DRAFT FOR DISCUSSION PURPOSES PREAPRED IN COOPERATION WITH SORAINEN AND RICHARD KEMMISH CONSULTING LIMITED

INTRODUCTION OF A COVERED BOND AND SECURITISATION LEGAL AND REGULATORY FRAMEWORK IN LITHUANIA

April 2017

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1. Executive summary

Covered bonds and securitisations both have the ability to provide significant benefits for Lithuania including improvements to the funding of the real economy, increasing the stability of bank funding and generating a group of high liquidity and credit quality investments for domestic investors.

In order to realise these benefits, enabling legislation will be required and, in the case of covered bonds a supervisory framework will need to be established. Although covered bonds and securitisations differ in certain significant ways there are substantial legal synergies which suggest that the two instruments should be legislated in the same act of parliament, whilst recognising the need for a clear distinction between them. In Lithuania in particular covered bonds will allow banks to reduce their dependence on both short term and potentially volatile deposit funding and on funding down-streamed from their parents. Securitisation will improve the access of large institutional borrowers to the capital markets and reduce their dependence on bank financing.

The development of both securitisations and covered bond markets are key objectives of the European Commission's Capital Markets Union initiative.

In this concept paper we address the following points

Section 2. Scope
This project was established by the EBRD and funded by the Shareholder Special Funds administered by the EBRD in order to advise and support the Ministry of Finance in the introduction of covered bonds and securitisations legal and regulatory framework. The project is led by the EBRD Local Currency and Capital Markets Team.
This paper is designed to ensure a broad understanding of both of the instruments and to facilitate a consensus on the process by which they may be introduced into Lithuania.

After a stakeholder consultation, this concept paper will form the basis and a roadmap of a draft securitisation and covered bond law.

Section 3. Description of Asset Backed Securities and Covered Bonds
Asset Backed Securities ('ABS' or 'securitisations') and covered bonds are both secured debt instruments. In the case of ABS, investors have recourse only to a pool of assets, in the case of covered bonds they additionally have recourse to the issuer of the bonds. In addition covered bonds are restricted with regards to their underlying assets and the entities which can issue them.

Both ABS and covered bonds are currently referred to in various European Union Directives, primarily dealing with their treatment by investors. As part of Capital Markets Union it is possible that both products will be defined and regulated by a specific EU legal act although the responsibility for the drafting of a law will remain a member state competency.

In the case of covered bonds this is likely to be a principle-based directive specifying the standard which national covered bond regimes must meet.

In the case of ABS the regulation is likely to define minimum standards for securities to benefit from preferential investor treatment, although there is currently no consensus on the details of this and agreement and promulgation of the regulation may take some considerable time.

Section 4. Structural alternatives

ABS are typically structured via the transfer of assets to an independent entity which issues bonds to fund the purchase. This requires several intermediate steps which may require legislative actions to facilitate.

Covered bonds on the other hand can viably be structured in different ways. We recommend that Lithuania adopts a model whereby assets are transferred to a separate SPV (as this term is defined in a glossary attached to this concept paper) which writes a guarantee of the issuer's obligations under the bond. This model helps to enhance the extent of segregation of the cover assets from the issuer (in comparison to the model where cover assets remain on balance sheet of the issuer) and, therefore, to enhance the quality and legal reliability of the priority claim enjoyed by the investor on the cover assets. This will achieve a high level of greater legal certainty for investors, will minimise the costs of establishing programmes (in comparison of the Special bank model or Agency model requiring a scale), in particular for smaller borrowers and will require less additional changes to existing laws, for example the insolvency code.

Other topics must also be addressed in a covered bond law and regulations.

Section 5. Building blocks of ABS and Covered Bonds

Building on the necessary legal structure for securitisations and our recommended legal structure for covered bonds we will need to put in place certain legal building blocks. In order to transfer assets into a bankruptcy remote entity (a 'special purpose vehicle' or 'SPV') and for these assets to provide sufficient protection for investors, certain amendments have to be made to Lithuanian law, in particular with regard to the establishment of a suitable legal entity, the appropriate means of asset transfer, the enforcement of collateral and the creation of security interests. In addition, legal certainty of tax regime applicable has to be established (see section 5.11).

Section 6. Economic considerations

Covered bonds will be significantly cheaper than other forms of term debt for Lithuanian banks. Furthermore they will allow a better matching of asset and liability maturity profiles and access to funding in turbulent market conditions. However, it should be noted that there is currently little requirement for term funding in this sector. This is a combination of factors including high deposit to loan ratios, parental funding, and a lack of a regulatory requirement to put in place stable term funding. These factors are unlikely to persist in the long term. A further consideration for a covered bond programme is the relatively high upfront costs of establishing a programme. As many banks active in Lithuania are also active in Estonia and Latvia, a covered bond law that allows assets also from these countries may help upfront costs to be amortised over a bigger quantity of funding.

Although securitisations have the potential to significantly enhance credit ratings and thus reduce the cost of funding assets it is difficult to quantify the potential economic saving without first understanding the uses to which the tool will be put.

Section 7. Decisions needed and next steps

On the basis of this concept paper we would appreciate feedback from all stakeholders on the concepts discussed. On the basis of this we propose to start drafting primary legislation which will further be circulated amongst all stakeholders before entering into the legislative process.

Appendices

Appendices to this paper describe the recommendations of the European Banking Authority with regard to covered bond laws and supervision, provide a cross-reference of the laws referred to in

this paper at both a national and European Union level and provide a glossary of terms used in securitisation and covered bond transactions.

2 Introduction

2.1 Scope of project

This paper has been produced as a part of a project undertaken by the European Bank for Reconstruction and Development ("EBRD") supported by Sorainen and Richard Kemmish Consulting Limited and funded by the Shareholder Special Funds administered by the EBRD.

The scope of the project is to advise and support the Ministry of Finance of the Republic of Lithuania as they develop Securitisation and Covered Bond markets. Specifically this is expected to include, inter alia:

- an analysis of the existing pertinent legal, regulatory and commercial conditions;
- advise with regard to legal and regulatory changes that are required to facilitate the development of these markets, expected to be in the form of primary legislation, amendments to existing legislation and supervisory regulations;
- discussions with all stakeholders of the risks and benefits of the proposed instruments and, as an outcome of such discussions, safeguards that need to be put in place;
- other support, as required.

2.2 Role of concept paper

The purpose of this paper is to identify issues that would be appropriate to address in order to introduce covered bonds and securitisations in Lithuania, to provide a roadmap for the necessary legal and regulatory process, to ensure a common understanding of the key topics and to request permission to proceed to the drafting of the proposed act of parliament.

This note is to be delivered to the Ministry of Finance for discussion purposes. Subsequently, the intention is to share and discuss it with key stakeholders and other interested parties.

2.3 Process overview

On the basis of this consultation paper we will seek a consensus of stakeholders on the broad topics to be addressed and the way to undertake these.

For both proposed instruments the next step will be the drafting of primary legislation which will then be subject to normal consultation procedures. This consultation will necessarily bring up more detailed topics that will need to be discussed by all parties.

The Act of Parliament and supporting laws will (inter alia):

- define covered bonds and securitisations and their broad parameters;
- amend certain other acts of parliament, for example to ensure that the proposed laws are compatible with the transposition of the Bank Recovery and Resolution Directive into Lithuanian law;
- specify the scope of secondary regulations to be enacted by the Central Bank on more technical aspects of;
- where necessary specify the appropriate investor treatment for the resultant securities including the transposition of existing investor directives into Lithuanian law;
- specify the consumer protection standards that must be adhered to.

Secondary regulations of the National Bank of Lithuania will then be needed to further clarify the legal and supervisory framework and provide all necessary safeguards.

3 Description of ABS and covered bonds

3.1 Definition of products and comparison

Covered bonds and securitisations are both ways in which bonds can be issued with the benefit of security over financial assets such as residential mortgages. There are similarities between the products in particular from a legal perspective, but also differences, in particular from an economic perspective.

The most significant differences are that a covered bond can only be issued by a credit institution, has full recourse to the issuer, is subject to special public supervision and can only be backed by certain specific assets.

A securitisation can also be issued by non-credit institutions, investors only have recourse to the underlying assets, there is no requirement under EU law for special public supervision and they can be backed by any assets which are sufficiently credit-worthy and which can be legally segregated from the issuer's balance sheet.

The differences are shown in more detail below.

	Covered bond	**Securitisation**
Issuing entity	Credit Institution (according to UCITS Directive 52(4)[1])	Typically credit institution but can be any legal entity
Eligible assets	Mortgages, public sector receivables, ships plus 'technical' assets including substitute collateral and derivatives – defined by Capital Requirements Directive and Regulations Typically eligible assets are defined more narrowly under national law	No legal restrictions. Any assets which can be legally identified and transferred to a special purpose vehicle and which rating agencies and investors consider sufficiently creditworthy. In practice, frequently mortgages and consumer loan receivables
Public supervision	"Special supervisory regime to protect the interests covered bond holders" – UCITS Directive[2]	No specific legislation. Normal supervision of issuer – depending on legal form - and

[1] List of laws and regulations referenced (at EU and local level) is provided in the Appendix 2.

[2] Supervisory regimes are frequently 'retrofitted' to contractually structured covered bonds – as happened in Netherlands and UK. The number of extant contractual programmes without a supervisory regime is now negligible, arguably not a covered bond at all (certainly not in any EU definition).

	Normal banking supervision and bond issuance requirements (e.g., Prospectus Directive)	bond issuance requirements.
National legislation	Typically comprises - A covered bond act - Secondary regulations of bank supervisor - Amendments to other relevant legislation - Rules for investor treatment of securities, typically transposed from EU Directives	Jurisdiction specific. In some countries 'Securitisation Act', in others amendments to existing legislation to facilitate securitisations (e.g. amendments to tax code), in others no new material legislation is required. Contract law typically 'backbone' of structuring
EU Legislation	Exemption from bail-in under Bank Recovery and Resolution Directive Favourable investor treatment of securities under various directives Discussion of possible covered bond directive is on-going (see section 3.2.2)	Exemption from bail-in under Bank Recovery and Resolution Directive Less favourable investor treatment of securities under various directives Regulation for "Simple transferable Securitisations" currently under tri-partite negotiations with Commission, Parliament and Council (see section 3.2.1).
Investor treatment	Lower risk weights for bank investors under capital requirements directive Lower risk weights for insurance investors, exemption from certain concentration ratios under Solvency Directive Exemptions from certain concentration ratios for investment funds under UCITS	Investor treatment generally covered in same directives but invariably with significantly worse treatment – for example higher risk weights. There is a proposal to improve some aspects of the prudential treatment for certain qualifying ABS under the STS initiative. However there is no consensus currently between the European Parliament and the European Commission on

	directive Eligibility for various tiers of eligible securities under liquidity coverage ratio rules Eligible as collateral in open market operations of European Central Bank Eligibility for covered bond purchase programme of ECB, subject to additional criteria	which ABS will qualify and what the new prudential regime will be. Eligible as collateral in open market operations of European Central Bank Eligibility for asset-backed securities purchase programme of ECB subject to additional criteria
Typical economic form	Fixed rate 3 – 20 years	Floating rate 1 – 5 years
Maturity structure	Bullet maturity. In the event of an issuer default it is possible that some forms of covered bonds are extended ('soft bullet' covered bonds or 'conditional pass throughs'). These features are increasingly common in newer programmes. No covered bond has ever extended. In the event of insolvency of the cover pool **and** of the issuer it is possible that some covered bonds accelerate to avoid time subordination of longer dated tranches. This also has never happened.	Typically pass-through – the bonds amortise along with the underlying assets. Senior bonds (class A) are usually amortised before more junior ranking tranches (class B), although senior ranking bonds can also be tranched by order of paydown (e.g. class A-1 pay down before class A-2 but both are pari passu with each other and senior to tranche B in credit terms).
Performance during global financial crisis - credit	No defaults Downgrades usually due to downgrade of sovereign credit ratings	Mixed Securitisations backed by 'prime' assets in Europe performed well
Performance during global	Very good.	Poor.

financial crisis – liquidity	Largely due to 'real money' investor base	Many leveraged investors forced to drastically reduce exposure to asset class
Issuer capital treatment	Capital neutral	Regulatory capital for assets can be reduced to the extent that risk is transferred to 3rd party
Inter-creditor treatment	Multiple, pari-passu, covered bonds are typically issued over time from the same programme, secured on the same pool of assets. All covered bonds rank equally. In the event, post issuer insolvency, that their differing maturities create a risk of 'time subordination' (longer dated bonds being de facto subordinated to shorter dated), measures are put in place to address this risk.	Bonds are typically tranched according to seniority (class A bonds are senior to class B, are senior to class C). More junior tranches pay a higher coupon, have lower credit ratings and typically, longer maturities.

3.2 EU legislative process

There is currently no EU directive or regulation that defines either covered bonds or securitisations.

The products are however referred to in many directives, regulations and elsewhere, typically these describe the appropriate investor treatment of the instruments. For example, the Capital Requirements Regulations specify the appropriate risk weight of covered bonds for bank investors if these covered bonds meet certain detailed criteria, in particular with regard to the underlying assets. These criteria are typically used de facto as the closest thing currently existing to an EU 'definition' of covered bonds. However, there are some slight differences in the definitions contained in the different Directives.

The investor treatment of covered bonds is far more favourable than that for securitisations. This largely reflects European Commission's attitude towards the comparative performance of the two instruments over the financial crisis.

As part of the Capital Markets Union initiative both a covered bond and a securitisation directive are being discussed.

In addition to their legal treatment, covered bonds have been purchased by the national central banks of the Eurosystem far more frequently than securitisations. This has taken the form of three covered bond purchase programmes, the latter as a part of the quantitative easing programme. The current asset purchase programme includes ABS purchases. Covered bonds and ABSs are also widely used as collateral in open market operations of the Eurosystem.

In the absence of a covered bond market in Lithuania the purchase programme has been unable to operate there. There is therefore substantial 'pent up' demand for Lithuanian covered bonds from the Euro central bank system.

3.2.1 Potential Securitisation Regulation

In September 2015 the European Commission published a draft directive detailing minimum quality standards for all securitisations and improved investor treatment for securitisations which meet a further, higher standard – the STS rules[3] (Standardised, Transparent Simple). Although the main criteria are very detailed, some of the key points are as follows:

- The originator must retain some form of economic exposure to the underlying assets which equate to at least 5% of the total risk. How this risk is calculated will be defined in future technical standards but it should be noted that a similar rule in the US allows multiple ways in which originators can interpret the 5% value.
- Investors must undertake due diligence to ensure, inter alia, that the information that they will receive is sufficient, that they understand the structure of the securitisation and that they have sufficient risk management processes and controls in place.
- There must be a high standard of transparency with regard to deal documentation, the historic performance of comparable assets and the quality of the underlying assets disclosed on an at least quarterly basis. This should be independently audited to a high degree of confidence and a cashflow model of the transaction should be made available.
- Certain national supervisory minimum standards are set to ensure that the securitisations conform to the directive, that all risks associated with the securitisation for the issuer are addressed and that there are sufficient legal remedies available in case of a breach. It should be noted that this differs significantly from the supervisory standards for covered bonds in particular to the extent that covered bond supervisory standards include a 'duty of care' towards the investors under the UCITS Directive, article 52(4).

The European Council rapidly accepted the Commission text. However, the European Parliament, made a counter-proposal[4] in February 2016 in which it is significantly more difficult for originators to meet the criteria. Their proposal focuses on the implications of the 'moral hazard' argument (namely that if the originator of the assets is not sufficiently exposed to the economic risk of those assets they are not sufficiently incentivised to originate assets in a responsible manner) and the asymmetry of information between the originator of the assets and the bond investor. Some of the key areas of difference between the Parliament text and the Commission/Council text are as follows:

- Issuance should be restricted to financial institutions which are subject to normal capital and supervisory requirements;

[3] Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL laying down common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation and amending Directives2009/65/EC, 2009/138/EC, 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012

[4] DRAFT REPORT on the proposal for a regulation of the European Parliament and of the Council laying down common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation and amending Directives 2009/65/EC, 2009/138/EC, 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012 (COM(2015)0472 – C8-0288/2015 – 2015/0226(COD))

- Only regulated investors may buy the bonds;
- The special purpose vehicle which issues the bonds and owns the assets must be subject to EU law and resident in an EU member state;
- 20% of the total economic exposure to the assets must be retained by the issuer;
- Information concerning the underlying assets should be made available in a central data repository (such as the European Data Warehouse[5]);
- Higher standards of reporting and due diligence are required.

Tri-partite negotiations to reconcile these two texts and agree a final regulation started in January. It is unlikely that the process will be finalised in the near future.

3.2.2 Possible Covered Bond Directive

In 2014 the European Banking Authority (EBA) published a report on EU Covered Bond Frameworks and Capital Treatment in response to a request from the European Commission to evaluate whether the current investor treatment of covered bonds was justified. In addition to confirming the treatment this report reviewed current practice in covered bond markets in member states and made a series of recommendations on 'Best Practices'. Although these recommendations have no legal status they are highly likely to form the basis for future EU legislation. Many member states have subsequently amended their covered bond laws and regulations to ensure full compliance with these recommendations.

The EBA recommendations are summarised in appendix 2 and can be found in detail at https://www.eba.europa.eu/documents/10180/534414/EBA+Report+on+EU+Covered+Bond+Frameworks+and+Capital+Treatment.pdf

In September 2015 as a part of the European Commission's Capital Markets Union initiative, Commission launched a public consultation[6] on the covered bond market. In particular this consultation asked if there was evidence of fragmentation of the covered bond market along national lines during the financial crisis. Whether a more unified pan-European covered bond framework would enhance market functionality and if so what form this should take?

It was clear from responses received that market participants did not feel that there was evidence of market failure during the crisis but that this did not necessarily imply that a pan-European framework would be unhelpful. Furthermore it was widely held that a pan-European covered bond law applicable in all member states (a so called "29th regime") would be too difficult to implement from a legal and practical perspective and would yield only very limited benefits.

Further recommendations for the covered bond market were published by the EBA in December 2016. Although based on the 2014 'best practice' principles they elaborate on these in several areas. The European Commission is currently studying these recommendations with a view to deciding on whether legislative action is justified. In the interests of disclosure, one of the authors of this concept paper is acting for Commission on this study.

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[5] Annex VIII Loan-level data reporting requirements for ABS of the M2 Guideline 2015/510 .

[6] COMMISSION STAFF WORKING DOCUMENT Feedback Statement on the Green Paper "Building a Capital Markets Union" Accompanying the document Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions Action Plan on Building a Capital Markets Union

3.3 Benefits and risks of ABS

To the extent that the credit rating of a securitisation can be totally delinked from that of the originator of the assets they can achieve a very low cost of financing for that bank whilst at the same time accurately matching the maturity profile of the assets to that of their funding.

The costs of funds argument is particularly relevant for non-bank issuers who do not have access to cheaper deposit, short term or central bank funding facilities that banks normally benefit from (subject to eligibility criteria).

Whilst there is increasingly a regulatory requirement for the issuer to maintain some exposure to the riskiness of the underlying assets, securitisation can be used to limit that exposure and reduce catastrophic downside risks in the banking system. This risk mitigation aspect of the instrument is reflected in the possibility to reduce regulatory capital requirements for the assets securitised.

From a theoretical perspective it is optimal for the risks and returns of assets to be allocated to the economic player who is best suited to own these risks and returns which is not necessarily the bank which originated them.

Even with a requirement to retain some form of economic exposure to the underlying assets there is a moral hazard risk inherent in the instrument to the extent that the entity responsible for the origination and servicing of the assets is not fully exposed to their risk.

Historically the investor base for securitisation has been highly leveraged and, as such its capacity to buy securities fell significantly during the financial crisis introducing price volatility and precluding refinancing. The highly leveraged investors are no longer a significant part of the securitisation buyer base.

Most of the downside risks that have historically been associated with securitisations are mitigated by the European Union's STS proposals (see section 3.2.1).

From the perspective of the borrower whose loan is included in the pool certain safeguards should be put in place in a securitisation structure to ensure that their inclusion in the pool is in no way detrimental to their consumer rights. Of particular note are:

- Their rights to banking secrecy;
- Their ability to set-off amounts which they owe the bank against deposits which they have with them in the event of the bank's failure. The European Union guarantees of retail deposits significantly ameliorates this problem;
- Their rights to amend contracts, for example to request a new mortgage product;
- Their rights under the Mortgage Credit Directive, in particular their right 'reasonable forbearance' in the event of financial stress.

Specific benefits to the Lithuanian economy of a functioning ABS market include:

- reducing the currently heavy reliance of corporates on bank funding which in turn will reduce the potential volatility of funding availability;
- providing a means for Lithuanian banks to reduce the potential for extreme downside losses associated with their exposure to a narrow pool of highly correlated assets;
- diversifying the set of domestic assets available to fixed income investors from its current relatively low base.

3.4 Benefits and risks of covered bonds

By virtue of their enhanced security covered bonds achieve a significantly higher credit rating than the entity which issues them. This can theoretically be of the order of 8 notches of rating uplift although in practice this is often constrained by the maximum rating achievable in any given country and/or by the AAA upper bound to ratings.

Given the rating uplift and the preferential treatment that covered bonds attract for EU based investors, they can be issued at a significantly lower interest cost than unsecured debt, for longer maturities enhancing funding stability and improving asset and liability duration matching and can be issued in periods of extreme volatility when other bond markets may not be available.

The discipline of a detailed rating agency and supervisory review of the assets in the cover pool and the alignment of interests between the issuer and covered bond investors both requires and rewards the origination of safe, high quality assets for inclusion in cover pools.

From the perspective of investors, covered bonds provide a highly rated, liquid alternative to investing in government securities, thus reducing the credit nexus between the banking and public sectors. This is of particular significance for bank treasury investors who are required to maintain buffers of liquid assets under the LCR (Liquidity Cover Ratio) regulations. Covered bonds are allowed as Tier 1 assets for the purposes of these regulations alongside public sector securities.

Perceived risks of covered bonds are generally two-fold.

As with securitisations (see above), it is important that the inclusion of a mortgage in the cover pool in no way impairs the rights of the mortgage borrower, including their rights to banking secrecy, to negotiate new banking products and to benefit from consumer protection law. Safeguards must be put in place to ensure that no borrower is worse off as a result of their inclusion in the cover pool.

The ring-fencing of assets for the benefit of one class of creditors potentially creates a degree of subordination for unsecured creditors. Furthermore it reduces the stock of high quality mortgage assets that can, for example, be used as collateral for emergency funding facilities provided by the central bank

In some jurisdictions this risk is addressed by limits on the number of covered bonds that can be issued as a percentage of total asset on balance sheet, a requirement for a certain minimum level of high quality unencumbered collateral, or an incremental capital charge for excessive encumbrance. All of which mitigants could be calibrated to the riskiness of the issuer (for example, well capitalised issuers may issue more covered bonds before attracting an incremental capital charge).

Specifically in a Lithuanian context, the introduction of a functioning covered bond market will increase the stability of the financial system by reducing the current heavy reliance on short term deposits and enable Lithuanian banks to fund themselves independently from their non-Lithuanian parent companies.

3.5 Synthetic securitisations

All of the above comments relate to 'traditional' securitisations whereby assets are transferred to an SPV which pays for these assets by issuing bonds. A related instrument is known as synthetic securitisations.

Typically in a synthetic securitisation the credit risk of the assets is transferred to a special purpose vehicle (SPV). A synthetic securitisation typically involves a credit default swap contract, under which

a swap counterparty agrees to cover the losses suffered by the owner of the reference assets (usually the originator) if a credit event (usually a non-payment) occurs with respect to the reference assets. In return, the owner of the assets agrees to pay the swap counterparty premiums based on the perceived probability of credit events occurring.

The special purpose vehicle off-sets the risk most often by issuing bonds to third party investors the notional of which is written down if losses occur on the underlying asset pool. The SPV then uses the proceeds of this bond issue to purchase high quality collateral which it will sell in the event that it needs to make a payment to the bank under the indemnity.

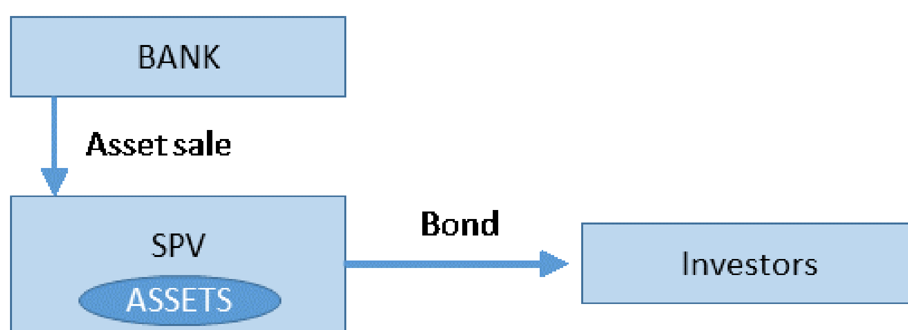
Synthetic securitisations are governed by bi-lateral contracts between the parties rather than by an act of parliament. Furthermore they are only used for risk capital mitigation purposes, not to provide financing for the banks. As such we have excluded them from the scope of the current project.

4 Structural alternatives

4.1 ABS structures

In the vast majority of cases (other than synthetic securitisations, see section 3.5) securitisations are structured as per the below diagram. The bank which originated the assets transfers them in some way (the diagram has shown asset sale, this is a simplification which will be discussed below) to a newly established legal entity (Special Purpose Vehicle or SPV) which funds the transfer via the sale of notes to investors. These notes are secured on the underlying assets and the notional and interest payments on these notes will depend on the assets paying down.

In order to achieve this outcome there are several legal 'building blocks', described below. The extent to which these are possible under current Lithuanian law or whether they require legal amendments is discussed in section 5 of this paper.



4.1.1 Special Purpose Vehicle

The entity which owns the assets and issues the bonds must be nominally independent of the bank in order to avoid consolidation for insolvency or resolution purposes and to avoid accounting or regulatory capital consolidation. Furthermore, the rating agencies will require the SPV to have independent controls to ensure that it acts in the best interests of bond holders.

Typically the special purpose vehicle is either wholly or partly owned by an entity other than the bank. In many jurisdictions they will also have independent directors.

To ensure that the special purpose vehicle will not enter into insolvency proceedings itself its activities will be restricted to the acquisition and funding of the assets (and absolutely necessary ancillary activities such as asset servicing and hedging). Furthermore bond investors will have no petition rights in the event of a default on any notes.

The legal form of the SPV varies by jurisdiction, for example it may be a fund or a non-financial corporation. In some countries a new legal entity has been created for this purpose (for example, in France the law has established an entity known as 'fonds de commun des créances'. In other jurisdictions entities established under foreign law have been used.

4.1.2 Asset transfer

The assets must be transferred to the SPV. There are numerous ways in which this can be done in most jurisdictions.

The method used should:

- ensure that there is a clear legal claim over the assets which cannot, for example, be challenged by unsecured creditors of the bank. This will include ensuring that the transaction cannot be re-characterised by a court in the event of the bank subsequently entering resolution or insolvency;
- transfer both the primary assets and the ancillary rights (for example both the loan and the security over that loan);
- be compatible with the terms of the underlying assets. In some cases mortgage loan agreements have restrictions on the ability of the bank to transfer the assets;
- ideally, the method of transfer should extinguish any rights to set-off of liabilities against assets the borrower may have with the bank.

If the above criteria are all met the transfer could be described as a 'true sale'.

4.1.3 Creation of security

Ideally the creditors of the SPV should benefit from a security over its assets. The creditors are primarily the bondholders but will also include derivative counterparties and potentially for example, third party asset servicers. The relative ranking of these creditors, in particular of the different classes of bond holders will be determined by an inter-creditor deed.

In some jurisdictions the benefit of the security is held by a security trustee for the benefit of secured creditors.

Security is not strictly necessary if the activities of the SPV can be sufficiently restricted to ensure that its actions will be identical to what would have occurred if such security had existed.

4.1.4 Credit enhancement

In order to achieve the highest possible credit ratings, features will need to be included in the bonds to protect bondholders. The most frequently used form of credit enhancement is to transfer more assets to the SPV than the bonds which it issues (over-collateralisation). The difference is typically funded by the SPV via a subordinated loan from the bank.

Other forms of credit enhancement include:

- tiering of securities issued by the SPV (Tranche B of notes effectively acting as over-collateralisation for Tranche A, Tranche C for Tranches A and B, etc.);
- spread retention. To the extent that the underlying assets yield more than the notes issued some or all of the interest difference may be retained in the SPV to protect against future credit losses on the assets, and
- swaps of the interest rate due on the assets for the interest rate due on the bonds. The SPV will typically enter into these swaps directly with the bank but the rating agencies will require that the swap terms include a requirement that the bank replaces itself as a swap counterparty in the event that it is no longer sufficiently credit-worthy.

Typically credit enhancement methods are defined in a transaction by contract, not statute. Other than to ensure that none of the possible credit enhancement methods contravene the law or banking supervisions this section is included for information only.

4.1.5 Creation of bonds

The bonds issued by the SPV will be subject to normal laws, regulations and supervision for bond issues by Lithuanian companies and/or financial institutions.

The securities will probably need to include inter-creditor agreements (to the extent that tranches of notes with different ranking security will be issued) and will require consent solicitation rules. Lithuanian law sets the general principle of equal treatment of investors having securities granting similar proprietary and non-proprietary rights; hence, contractual arrangement adhering to the said principle should be recognised by Lithuanian law. However, such ranking of securities might not be enforceable in case of issuer's insolvency as ranking of the creditors in case of bankruptcy is established by law.

To the extent that the securities will be sold to non-Lithuanian investors cross-border tax and settlement issues may also need to be addressed.

4.1.6 Tax neutrality

All aspects of the transactions should, wherever possible, ensure that no new taxation liabilities are incurred for the bond issuer/originator of the assets or the investor other than to the extent that they would for a normal bond issue.

This includes, inter alia,

- any tax including stamp duty on the transfer of assets to the SPV,
- tax of profits at the SPV other than to the extent that this tax would otherwise be incurred by the bank
- tax on the method by which profit is extracted from the SPV to the bank
- withholding tax on the bond coupons

A failure to achieve tax neutrality and the creation of any material new forms of tax would be likely to make the transaction uneconomic for issuers and defeat the purpose of the legislation.

4.1.7 Other building blocks

Several other features are typically required to structure a securitisation but normally are governed by contract law rather than defined by statute.

For example: the bank will need to service the assets on behalf of the SPV, typically under a separate legal document. Rating agencies will require that it is possible to service these assets via a third party should that be necessary.

To the extent that the interest under the bonds is less than that on the underlying assets and that the difference is more than sufficient to make whole any principal loss, the difference will need to be transferred from the SPV to the bank.

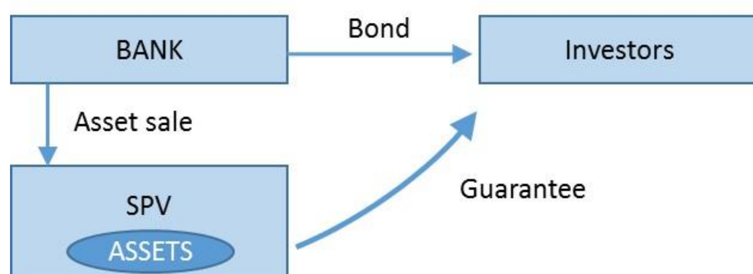
4.2 Covered bond structures

In existing jurisdictions covered bonds are typically structured in one of four ways. All four of these alternatives are widely used, accepted by investors, compatible with EU law and the recommendations of the European Banking Authority and achieve a similar degree of credit protection for investors. The choice of which alternative to adopt is typically based on practical legal and commercial considerations in any given jurisdiction. Some larger jurisdictions such as France allow more than one structural alternative due to differing requirements of commercial entities there.

Due to the substantial synergies that exist between a securitisation and covered bond law and due to the high degree of legal certainty which can be generated we recommend that the separate Guarantor model (4.2.1) is adopted in Lithuania.

The four types are as follows.

4.2.1 Separate Guarantor model



Used in (for example): UK, Netherlands, Italy

Bonds are issued by a credit institution which at the same time transfers a pool of assets to a separate legal entity (a 'Special Purpose Vehicle' or 'SPV'). The SPV issues a guarantee of the bonds issued secured on the assets that have been transferred to it. The issuer is obliged to buy-back impaired or ineligible assets and replace them with suitable assets on a revolving basis to ensure that the SPV is able to meet any obligations under the guarantee. The SPV is consolidated with the issuer for accounting and regulatory purposes but not in insolvency.

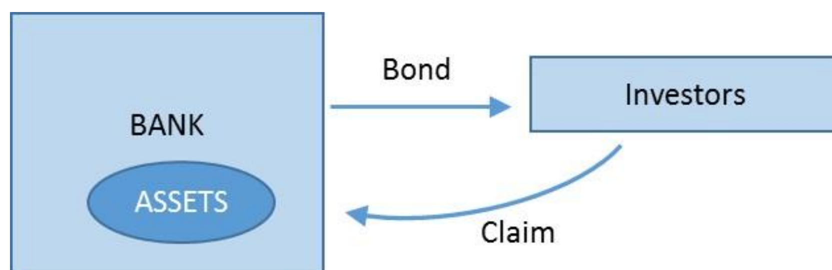
This structure, achieves a very high degree of legal certainty. As the assets are transferred to the SPV before they are needed (that is before an insolvency of the bank) there is no possibility that the assets can be in anyway impaired by the insolvency or resolution of the bank, provided that the transfer is correctly legally structured.

No specific insolvency legislation is needed. In the on-balance sheet model, described below, amendments to insolvency regimes are typically extensive and onerous.

Furthermore, the SPV as a distinct legal entity already existing is able to enter into contracts, for example to refinance or hedge the assets with third parties without the consent of the insolvency court or the establishment of a 'legal personality' for the cover pool.

This structure contains many legal similarities with securitisations and is frequently seen in countries where both financing tools are used in order to reduce unnecessary amendments to existing laws.

4.2.2 On-balance sheet model



Used in (for example): Germany, Spain

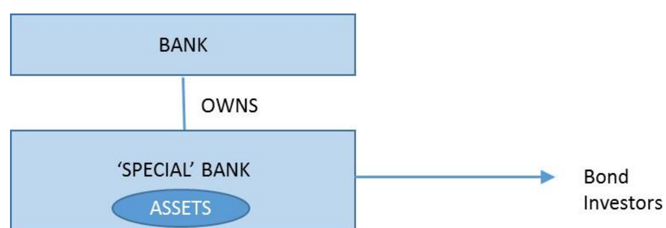
Bonds are issued by a credit institution which at the same time designates a pool of assets to serve as collateral for that issue in the event that the issuer defaults or enters resolution. The issuer is obliged to maintain the pool of assets on a revolving basis to ensure that it provides adequate protection for covered bond investors.

This is structurally straightforward but requires substantial legal technology to ensure that:

- the claim of the covered bond creditors survives the insolvency or resolution of the issuer,
- that other creditors cannot establish a claim against these assets,
- that normal bankruptcy procedures such as a stay on payments or the exercise of claims can be set aside and that the pool and associated liabilities can be transferred to a third party if required.

All of which require extensive additional legal changes to be introduced with costs, risks that they do not achieve the desired aim in practice and potential unintended consequences.

4.2.3 Special bank



Used in (for example): Poland, Ireland, France (partial), Hungary

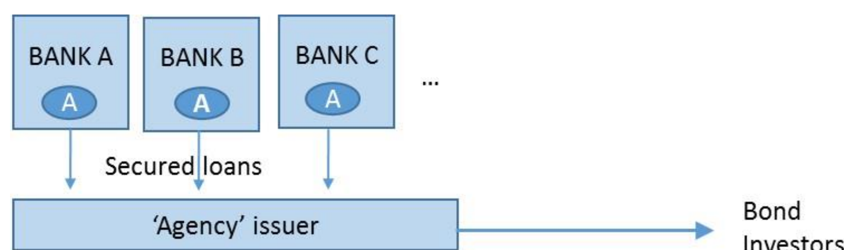
Bonds are issued by a bank which was established specifically to originate, own and finance qualifying assets and whose actions are limited by law to these activities. Typically this bank is a wholly owned and guaranteed subsidiary of a universal bank.

This structure provides a high degree of legal certainty for investors, in addition to credit protection from the capital and supervision of the issuing entity.

This model is however substantially more onerous and expensive for issuers to put in place. The cost of capitalising and establishing a supervisory framework for the new entity and the cost of ongoing bank regulation make it only viable for larger issuers in larger countries with substantial funding needs over which to amortise the costs. Furthermore there is increased scrutiny of the relationship

between the parent and special bank with some investors and regulators expressing reservations about the viability of the model going forward.

4.2.4 Agency



Used in (for example): Norway (partial), Switzerland (partial), France (partial)

A new legal entity is established which advances loans to several issuers secured on their pools of underlying assets. This entity (sometimes referred to as an agency) issues bonds on the basis of these secured loans. There are many variations on this basic model.

This structure can be a cost effective tool for smaller issuers. In many cases (in particular Switzerland and France) this is an old financing structure which has been modified over time in order to better conform to developments in the covered bond market. It is however reliant on high volumes of assets to amortise the costs of establishing the agency and is unlikely to be appropriate for a relatively smaller mortgage market such as Lithuania.

This structure is broadly similar to that used by the Federal Home Loans Boards in the United States.

4.3 Additional features of a covered bond law

In addition to the features which are in common with the securitisation law (section 4.1) and the determination of the broad legal structure (section 4.2), the covered bond law needs also to address certain differences and additional features. This includes the requirement that the covered bonds conform to European Union law (currently specifically article 129 of the capital requirements regulations) and the recommendations of the European Banking Authority.

In summary:

4.3.1 Definition of assets

The assets which may be used to back a covered bond are defined in article 129 of the Capital Requirements Regulations. However most countries apply more stringent rules and all use more detailed asset definitions.

Key decisions that will be required include:

- whether to allow just residential mortgages or to also allow commercial mortgages and public sector receivables as are allowed under the Regulation;
- how to define the asset type (for example whether a 'mixed-use' property is primarily commercial or residential);
- whether to impose limits on certain types of exposure;

- how to value properties (for example according to a market value or a mortgage lending value);
- limits on the ratio of the loan outstanding to the appraised value of the property, and how to calculate this ratio;
- the eligibility of mortgages in arrears for the cover pool;
- definitions of and limits on 'substitute assets' – assets other than the primary asset class included in the cover pool, for example to mitigate against liquidity risk.

Wherever possible the rules governing the above points should be in line with both existing rules and market practice.

In addition to the primary assets the laws and regulations will also need to specify criteria with regard to substitute assets and derivative contracts.

Substitute assets are typically high quality, near cash assets that are held, for example to meet imminent bond repayments. Criteria for these are specified under article 129 of the Capital Requirements Directive but may need to be augmented by national regulations.

Derivatives should be included in the pool only to the extent that they hedge mismatches between assets and liabilities. Furthermore they should be based on a modified version of normal ISDA documentation (for example to prohibit netting, or automatic termination on counterparty insolvency) and should rank pari passu with covered bond holders.

4.3.2 Obligations to buy back

The issuer will have to repurchase and replace assets in the cover pool for reasons of credit (the mortgage has gone heavily into arrears), eligibility (a change occurs which generates a breach of the eligibility criteria), or other reasons.

The law will need to both oblige the issuer to undertake this and ensure that the method of asset transfer to the SPV can accommodate it.

4.3.3 Investor protection

Many features will need to be included in the law and/or secondary regulations in order to protect the interests of covered bond holders. The primary source of protection against credit losses in the underlying assets is over-collateralisation, that is including assets in the pool that exceed the total value of bonds and other liabilities of the pool.

Over-collateralisation can be calculated on the basis of the net present value of the assets and the liabilities, nominal value, or both (or, in a small number of countries some other method such as 'prudent market value').

Typically:

- an absolute minimum level of over-collateralisation is specified in the law, currently this is frequently either 3% or 5%.
- The supervisor is empowered to set a higher over-collateralisation on a case by case basis. This is calculated with reference to the assets in the pool, the features of the covered bond programme and the credit-worthiness of the issuer. It may be set after the use of 'stress

tests' – a series of adverse assumptions about economic and credit conditions. These stress tests in turn may be specified in the law or regulations or may be set by the supervisor based on current conditions.

- Issuers contractually commit to maintain a higher level of over-collateralisation in order to ensure the highest possible credit rating.

In addition to over-collateralisation, rules will need to be put in place to ensure that the pool has sufficient liquidity to meet obligations as they fall due. This is analogous to the liquidity cover ratio rules for banks. There are however multiple ways to calculate it based on, inter alia, the nature of the underlying assets.

4.3.4 Implications of the segregation of bond issuer and asset owner

As the issuer of the bonds and the holder of the assets are separate legal entities the law, secondary regulations and contractual terms will need to accommodate the below insolvency structure.

The bonds are full recourse obligations of the issuer and benefit from a guarantee from the SPV. The issuer pays an 'arm's length' fee to the SPV for the provision of this guarantee.

In an event of default under the issuer's obligations under the bonds the guarantee is activated and the SPV is obliged to make payments under the bonds according to the original schedule of interest and principal. At this time the SPV claims under an indemnity against the insolvency estate of the issuer an amount equal to the principal and future interest payments. That is the claim under the indemnity is accelerated whilst the payments under the bond are not.

Only in the event of the cover pool's subsequent insolvency will payments under the bonds themselves be accelerated.

4.3.5 Treatment of cover pool in insolvency

Post issuer insolvency the SPV should be empowered by the law to enter into contracts as and when required to ensure the continued service of the underlying bonds. These contracts will include, for example the ability to enter into funding secured on the assets (either in the form of covered bonds, securitisations or asset sale or repo) and the ability to enter into derivative and asset servicing contracts.

The non-bank nature of the SPV may influence its ability to enter into these contracts, for example to repo the underlying assets with the central bank. This should be taken into account in the legal drafting process.

The law may need to establish a new legal entity (traditionally a 'Special Administrator') to manage the SPV post insolvency.

If bankruptcy proceedings are initiated against the issuer, the proceedings are limited to the general estate of the issuer, and that the special estate and the debts and obligations it covers do not form part of the bankrupt estate of the issuer. Moreover, the proceedings do not cause the obligations and debts of the special estate to become due and payable.

4.3.6 Supervisory regime

The day to day supervision of covered bond programmes should be undertaken jointly by the supervisor and an independent agent appointed by the issuer (typically referred to as a cover pool

monitor). The criteria for the cover pool monitor and the division of monitoring and supervising responsibilities will need to be specified.

The supervisor will need to specify the nature of the supervisory regime in three main sections:

1. approval to issue, licensing. This will include for example whether licensing is on a programme-by-programme or bond-by-bond basis and what information should be supplied to the supervisor;
2. on-going supervision. This will include for example the extent of the supervisors on-going responsibilities and powers;
3. post-insolvency powers and responsibilities.

The above features will be included in both the primary law and secondary legislation. For reasons of efficiency the details of these features should be included in secondary legislation wherever possible and primary legislation used mainly to allow this to happen (for example, granting the supervisor the right to set regulations).

5 Building blocks of ABS and covered bonds

5.1 Current status

Lithuania has no special law that specifically addresses securitisations. Currently securitisations in Lithuania are made using foreign corporate structures, i.e. so far there were no securitisations with an SPV established in Lithuania. Lithuanian securitisations are made mainly by applying the general provisions of the Civil Code regulating the transfer of claim rights and creation of security, alongside (if relevant) respective corporate laws and laws normally regulating securities markets. However, the legal framework relevant to securitisations is gradually developing. It is worth mentioning that effective from 1 November 2016 private limited liability companies (in Lithuanian – *uždarosios akcinės bendrovės*) are allowed to publicly offer bonds due to the introduction of the new Law on Protection of Bondholders and respective amendments to the Companies Law (before that date capacity to publicly issue bonds was vested within public limited liability companies (in Lithuanian – *akcinės bendrovės*) only).

Covered bonds in Lithuania are specifically regulated by the Mortgage Bonds Law introduced in 2003 with the aim of creating a system of mortgage lending which would incentivise long term savings intended to finance mortgages and be attractive to borrowers due to low interest rates. Needless to say that the law did not achieve its aims in creating a mortgage lending system as only one bank attempted to test in practice the issue of mortgaged bonds in Lithuania.

5.2 Incorporation of special purpose vehicle (SPV)

We suggest that the securitisation law establishes the following features of the SPV:

- simple procedure for an SPV to qualify as a securitisation vehicle (e.g. mere statement in articles of association that SPV is subject to provisions of securitisation law);
- restriction of activities of SPV by law, i.e. nature of securitisation undertaking's activity should be limited to acquisition of (or assuming the risks related to) the assets, claims and obligations assumed by third parties or inherent in third parties activities and issuing securities; hence, any activity that may qualify as entrepreneurship, including creation of additional indebtedness in SPVs, should be prohibited by law (this does not, however, limits the SPV's right to assign/sell its assets and pursue some specific types of transactions similar to securitisations, e.g. securitising existing portfolios and partially drawn credits without triggering professional credit activity which requires authorisation, say, one needed for consumer lending);
- ability to create SPV using several possible legal forms, e.g. public limited liability company (*akcinė bendrovė)*, private limited liability company (*uždaroji akcinė bendrovė*), without additional minimum capital requirements in comparison to those that are already established by respective corporate laws;
- no consolidation of SPV and originator from bankruptcy law perspective;
- as simple as possible management structure (ideally – no employees in SPV, where all activities performed through the agents who will be subject to wide contractual limitations and restrictions, e.g. non-petition, limited recourse, etc.) in order to avoid additional administrative burden and extra costs;
- SPV shall not qualify as a financial institution subject to requirements of Law on Financial

Institutions;

- simple and cheap liquidation procedure upon expiry of SPV, e.g. upon achieving the objectives SPV was created for (discharge of all the obligations against investors, transferring remaining profit to originator etc.);
- independent (from originator) governance;
- no authorisation, licencing, permits for SPV if it is used only as a securitisation vehicle (e.g. no consumer credit licence requirement if consumer loans are securitised; no obligation to comply with the laws regulating activities of financial institutions);
- principles of interaction with originator (e.g. peculiarities of servicing arrangement).

An SPV in Lithuania may be established following general provisions of the Civil Code (book II "Legal Persons") and the Law on Companies regulating two types of legal entities with a limited liability: public limited liability company (in Lithuanian – *akcinė bendrovė*, abbreviation - *AB*) or private limited liability company (in Lithuanian – *uždaroji akcinė bendrovė*, abbreviation - *UAB*).

As mentioned, earlier only public limited liability companies were allowed to publicly offer bonds, however effective from 1 November 2016 private limited liability companies enjoy this right as well.

The Civil Code expressly establishes severability of liability of legal entity and its participants. Exceptions to that rule might be established by law or incorporation documents of a legal entity. One of the statutory exceptions to that general rule is related to bad faith of the participant, i.e. if a legal entity is not capable of fulfilling its obligations due to the fact that the participant acted in bad faith, the participant shall be held liable for the obligations of that legal entity, however, only to the extent that the legal entity is not capable of fulfilling them itself (subsidiary liability). A legal entity is liable for its obligations by the assets held by it by the right of ownership or trust.

Legal entities act on the basis of their incorporation documents (articles of association, act of incorporation etc.). So, the possibility of restricting the activities and defining the duration of SPV may be achieved through respective limitations in its articles of association (by indicating objectives, activities and duration of the SPV). If the term of a legal entity is related to the occurrence or disappearance of respective circumstances (e.g. establishment and management of respective covered bond program), then the fact of occurrence, disappearance thereof is determined by the management bodies of a legal entity and liquidation procedures of a legal entity shall commence. However, regardless of a limited capacity established in the articles of association of the SPV, the latter being a private legal entity generally may pursue any activity and acquire any civil rights and obligations[7].

Further, transactions violating the capacity of the legal person may be declared void[8]. Therefore, if the SPV concludes a transaction exceeding its capacity, the mere disclosure of the Articles of Association limiting its capacity is not sufficient ground to challenge the transaction as the law allows a private legal entity to generally pursue any activity, therefore, the proof that the counterparty

[7] Article 2.74 of the Civil Code

[8] Article 1.82 of the Civil Code provides that transactions concluded by the management bodies of a private legal entity violating (i) the competence of these bodies established in the documents of incorporation or (ii) the objectives of a legal entity may be declared void provided that the counterparty acted in bad faith, i.e. knew or ought to have known that transaction is contrary to the objectives of a legal person concerned.

deliberately acted in bad faith is needed. This might be avoided if the activities of the SPV are restricted by law. Similarly, disclosure of the competence of the management bodies of a private legal entity is not sufficient proof of the counterparty's bad faith and, consequentially, grounds of voidability of the transaction[9].

The right to challenge the transaction on the above grounds is possessed by the legal entity itself, its founder(s) or a participant(s). The laws may also specify other persons entitled to challenge the transaction (e.g. bankruptcy administrator).

Hence, introduction of a special legal framework for SPVs (restricting their activities, easing the burden of proof in case of *ultra vires*, establishing special legal status of securitisation vehicles) would allow the achievement of a better level of legal certainty, benefit the interests of originators, investors and contribute to the successful usage of SPVs in covered bonds/securitisations.

5.3 Asset transfer

We consider that sale-purchase is the most appropriate contractual instrument for covered bonds and securitisations, however, respective provisions of law regulating securitisations and covered bonds (as the case might be) should develop sale-purchase by:

- adding some features of universal asset transfer enabling the avoidance of consents and individual notifications;
- establishing rules for public notification to the debtors;
- enabling simple and low cost transfer of collateral;
- allowing broad list of assets eligible for securitisations (loans, mortgages, non-performing loans, lease receivables, trade receivables, receivables of the financial institutions, as well as tangible (e.g. equipment) and intangible asset classes (e.g. intellectual property), both existing and future ones);
- establishing respective limits on the LTV ratios and restrictions on the maximum percentage that different types of assets may represent in the asset pool securing covered bonds;
- eliminating any possible uncertainties as to actual transfer of title ("true sale") instead of mere creating security interests.

Pursuant to the Civil Code title to the assets may be transferred applying general provisions of the Obligation law regulating assignment of a claim alongside either of the following institutes (depending on the case): (i) sale - purchase (Chapter XXIII "Sale - Purchase" of "Obligations Law") or (ii) Factoring (Chapter XLV "Factoring" of the "Obligations Law"). Further we shall elaborate on particular aspects of assignment of a claim and sale-purchase (factoring as specific instrument having different objectives would be mentioned for explanatory reasons only).

5.3.1 Assignment of a claim

Chapter VI "Assignment of Creditor's Claim" of Obligations Law lays down the general provisions according to which a creditor's claim may be assigned. Provisions of this chapter, being the general

[9] Articles 2.83, 2.85 of the Civil Code

institute for assignment, are applicable together with the specific norms of the Civil Code (say, sale-purchase) or the other laws and to the extent the specific norms do not establish otherwise. There is no restriction as to creditor whose claim might be assigned according to provisions of this chapter (bank, merchant assigning trade receivables[10] etc.). It allows assignment of existing or future claims. Together with security backing the claim all ancillary rights are also assigned based on provisions of law. Generally no consent of the debtor is needed for such assignment; however there may be specific statutory or contractual limitations for the assignment.

Restrictions to assign

In order to endorse covered bonds and securitisations we see that any requirements limiting the assignment have to be removed in case of the assignment to the SPV.

A claim cannot be validly assigned under Lithuanian law if:

(i) such assignment would violate the law (e.g. license is needed for acquisition of particular assets) or contract (e.g. assignment of a claim is contractually restricted) or if the person of the creditor is of essential importance to the debtor[11],
(ii) no recourse is feasible against such a claim[12],
(iii) the claim is inseparably related to the original obligee (e.g. claim for maintenance, claim for compensation of damage caused by health injury or loss of life)[13].

Cases (ii) and (iii) establishes statutory prohibitions to assignment and claims indicated therein are not eligible for assignment. Below are some other examples of statutory limitations on assignment of claim the failure to meet which might render the assignment null and void:

- in case of third party hypothec[14]", i.e. where a claim is secured by the third party pledgee/ mortgagor (in Lithuanian – *svetimo daikto įkeitimas/ hipoteka*), the consent of the owner of the collateral must be obtained for assignment of a claim;
- licencing of the activity of legal persons[15], i.e. where the law so requires, a legal entity may start pursuing some activity only provided that the respective license is obtained (e.g. in case of transfer of consumer loan receivables, the acquirer shall be authorised as consumer loan provider[16]);
- there may be some restrictions deriving from public procurement (in Lithuanian – *viešieji pirkimai*). Any amendments to public contracts[17] are prohibited (with the exception of the terms and conditions of the public contract that can be amended without prejudice to the

[10] Unless other institutes of the Civil Code regulating specific agreements (e.g. factoring which establishes specific requirement for the transferee (factor)) or specific laws are applicable.
[11] Part 1 and part 6 of Article 6.101 of the Civil Code
[12] Part 1 of Article 6.102 of the Civil Code
[13] Part 3 of Article 6.102 of the Civil Code
[14] Article 4.181 of the Civil Code
[15] Article 2.77 of the Civil Code
[16] Article 22-1 of Consumer Loan Law
[17] Following part 1(5) of Article 2 of the Directive 2014/24/EU on public procurement and repealing Directive 2004/18/EC '*public contracts*' means contracts for pecuniary interest concluded in writing between one or more economic operators and one or more contracting authorities and having as their object the execution of works, the supply of products or the provision of services. Generally it includes all contracts concluded with the State institutions, State owned legal entities or other purchasing organisations.

principles and goals of public procurements, and subject to the consent of the Public Procurement Office (**PPO**))[18];

- in case (i) where the person of the creditor is of essential importance to the debtor, consent of the debtor is needed[19].

Some perfection requirements

The law should establish one-off action for re-registration of a pool of assigned registered collateral instead of multiple and costly piece-by-piece re-registrations.

The Civil Code establishes some perfection requirements for the assignment of registered security, the failure to meet which shall not render the transaction null and void, but might bring other negative consequences, notably:

- assignment of claim secured by the registered pledge or mortgage may be used against third parties acting in good faith once such assignment is registered with the Mortgage Register of the Republic of Lithuania (in Lithuanian – *Hipotekos registras*)[20];
- assignment of a claim secured by possessory pledge may be used against third parties once the possession of the pledge object is transferred to the new creditor[21],
- assignment of a claim right has to be registered in a public register if a claim itself was registered in a public register (usually this is the case with pledges or mortgages)[22].

Amendments enabling the easy and simplified registration of the assignment of collateral (when required) is a core factor for covered bonds/securitisations in Lithuania, as currently due perfection forms a substantial part of the securitisation costs from a financial and time perspective. For more details related to current regulations, please refer to section 5.5.2 “*Transfer of mortgage or pledge”* below.

For assignment of other collateral, please refer to section 5.5 “*Transfer of collateral”* below.

Notification

We consider that public notifications of the assignment indicating categories of assets assigned and serving the purposes of a legal notification should be established. This would allow the assignee to claim that he has a valid and enforceable title, where practical aspects on how further to instruct the debtors, if at all, should be left to the decision of the parties.

According to the Civil Code failure to notify the debtor on assignment of a claim does not render the transaction null and void (subject to limitations indicated above), however it would bring the following consequences:

- assignment of claim, with some exceptions, may not be used against the debtor and third parties (e.g. security providers under the contracts);

[18] Article 18(8) of the Law on Public Procurement
[19] Part 6 of Article 6.101 of the Civil Code
[20] Articles 4.189 and 4.223 of the Civil Code
[21] Article 4.223 of the Civil Code
[22] Article 6.109 of the Civil Code

- the debtor may fulfil its obligations to the initial creditor or to the one of successive creditors (if a claim is assigned several times), and such fulfilment shall be deemed to be proper and valid and the assignee may not challenge such fulfilment[23];
- the debtor may set-off its claims against the initial creditor which became due after assignment (while notification limits the debtor's set-off right to the claims which became due before the notification)[24];
- the debtor shall have the right to set up against the assignee (the new creditor) all the defences which it was entitled to set up against the assignor at the time of receiving the notification on assignment of a claim[25];

Given that securitisations are usually made without notifying the debtors (unless in exceptional cases, e.g. insolvency of originator), the securitisation framework should establish a possibility of public notification.

Responsibility of the assignor

The legal regime should endorse contractual arrangements which carve-out the assignor's liability in case of the debtor's incapacity to meet its obligations, as in securitisations and covered bond practice there are contractual methods to address this (obligation to buy-back etc.).

The Civil Code establishes that the assignor is liable against the assignee for validity of the transferred claim, however bears no liability for the debtor's failure to fulfil its obligations, except in the cases where (i) the assignor secured fulfilment of such obligations or (ii) received remuneration for the assignment (in such case the assignor is liable for the debtor's incapacity only at the moment of assignment and to the extent of remuneration received)[26]. Notably, in case of factoring an exception applies, i.e. the assignor is not liable for the debtor's incapacity to fulfil its obligations except where the contract provides otherwise.

The above provisions on assignor's liability may not be always in line with the usual practice of securitisations and covered bonds.

5.3.2 Sale-purchase

The specific method of getting the assets into the SPV is the conclusion of a sale-purchase agreement. This institute is designed to mainly regulate sale-purchase of material objects (goods), nonetheless it may also be applicable to the sale-purchase of proprietary rights (claim rights inclusive) to the extent it does not contradict the nature and essence of those rights[27]. Hence, alongside the general provisions on assignment of claim (section 5.3.1.) the specific norms of the Civil Code regulating sale-purchase (including its various types) are applicable.

Given that the object of sales-purchase may be any things (goods), proprietary and claim rights, it is advisable that the list of assets eligible for securitisations would be as broad as possible. Also, the

[23] Part 1 of Article 6.106 the Civil Code
[24] Article 6.108 the Civil Code
[25] Article 6.107 the Civil Code
[26] Article 6.105 the Civil Code
[27] Article 6.306 of the Civil Code

laws should be more specific and recognise peculiarities of the sale-purchase for the securitisation purposes, e.g. the concept of the "true sale" of assets.

Business transfer as a going concern

We suggest using some features of the business transfer as a part of covered bond framework (e.g. universal nature, no consents, notifications).

Under Lithuanian law the business of a company (claim rights inclusive) may also be transferred by way of the transfer of the business as a going concern under so called transfer of enterprise institute (in Lithuanian – *įmonės perleidimas*)[28] (hereinafter referred to as "**the business transfer**").

A business transfer refers to a transaction regulated by a specific chapter of the Civil Code whereby a seller undertakes to transfer into the ownership of a buyer, as a complex of assets and liabilities, the whole enterprise or a substantial part thereof and the buyer obligates to accept it and pay the price[29]. The agreement on the business transfer must be notarised by the notary public.

In contrast, a piece-by-piece business transfer (effected applying the general provisions on transfer of claim rights together with specific provisions on sale-purchase of claim rights) refers to one or a series of separate asset transactions under which particular assets (and liabilities) are transferred.

Business transfer is a universal assignment / transfer of rights and obligations (universal transfer of assets, contracts, employees and obligations related to them). Therefore, generally no consents of counterparties /creditors are required for the implementation of a business transfer. Transfer of business does not allow the parties to cherry-pick the rights and liabilities to be transferred.

In the event of the business transfer the seller and the buyer are jointly and severally liable to the creditors of the enterprise (i.e. the transferee and the transferor are three years from the business transfer jointly and severally liable for the obligations to settle with the creditors of the enterprise under obligations which have arisen before the business transfer). The liability of the buyer is limited to the value of the purchase price paid by the buyer. In contrast, in piece-by-piece transfers the assets are acquired without the history and past (or contingent liabilities related thereto), therefore, in case of a piece-by-piece transfer there is no joint and several liability of the transferor and the transferee.

Although some aspects of business transfer (i.e. a) universal nature precluding from need to obtain consents of counterparties, b) greater resistance to possible challenges, c) integrity of transferred assets, ensuring continuity of agreements (including security) on the same terms so as if there were no transfer) are attractive, some are not in line with international practice of securitisations (e.g. joint and several liability). Besides, in not all cases the pool of assets transferred to the SPV would qualify as a business transfer which requires transfer of the whole enterprise or a substantial part thereof.

5.3.4 Securitisation and Fintech activities

The law should also take into account securitisation capacities in developing Fintech related activities (e.g. P2P-lending and crowdfunding).

[28] According to Articles 6.402 – 6.410 of the Civil Code
[29] Article 6.402 of the Civil Code

Current developments in crowdfunding platforms that might assist SME's attracting an alternative small scale funding have to be properly taken into account when developing the securitisation framework.

5.4 Creation of security

In order to ensure the investors' priority rights over the pool of assets the assets of SPV have to be either provided as collateral in favour of investors or ring-fenced from claims of other creditors by provisions of law.

Currently investors' priority rights in Lithuania might be created using the following instruments: (i) non-possessory pledge in accordance with the Civil Code; (ii) possessory pledge in accordance with the Civil Code; (iii) financial collateral under the Law on Financial Collateral Arrangements (as financial collateral is not broadly applicable in securitisations or covered bonds we would not further elaborate on this form of security); (iv) other instruments available in accordance with the Civil Code that can be used as security: suretyship and guarantee. In practise that means that security interests in favour of investors need to be dully contractually created, perfected (registered if needed) in order to create investor's priority rights over the pool of assets. We consider that the same result might be equally achieved by introducing respective provisions of law establishing, say (i) that articles of association of SPV (or even the law) may create investors' priority rights without additional creation of security for the benefit of investors (as outlined in Section 4.1.3 above) or establishing (ii) the statutory pledge over the pool of assets by provisions of law (no additional creation, perfection requirements except registration with the Mortgage Register).

5.4.1 Non-possessory pledge in accordance with the Civil Code

The Civil Code sets forth that non-possessory pledge may be established either by a unilateral declaration of the mortgagor or pledgor or by an agreement (which may be concluded either as a separate contract or included in the secured agreement) between the debtor, creditor and pledgor. Such agreement or unilateral declaration has to be verified by the notary public and registered with the Mortgage Register.

A non-possessory pledge comes into effect against its parties from the moment of the signing of a respective security agreement (unless the agreement itself sets forth otherwise). However, a non-possessory pledge can be used against third parties acting in good faith only when it is registered with the Mortgage Register. A non-possessory pledge is registered with the Mortgage Register by the notary who verifies it.

In case of a pledge by a unilateral declaration of the pledgor the same requirements apply, except for a requirement to indicate the creditor. Nevertheless, it can be used against third parties acting in good faith only when the creditor is registered with the Mortgage Register.

5.4.2 Possessory pledge under the provisions of the Civil Code

A possessory pledge may be established upon execution of a written security agreement and the transfer of the collateral to the pledgee. The possessory pledge becomes effective from the moment of conclusion of the security agreement and transfer of the collateral to the pledgee. It should be noted that the collateral which is transferred to the pledgee cannot be repeatedly pledged under the non-possessory pledge rules.

5.4.3 Suretyship

The suretyship is an accessory obligation (dependent upon the obligation of the principal debtor for which it has been entered into)[30] where the surety is liable with the principal on joint and several liability basis. Suretyship secures all the ancillary obligation of the principal, i.e. the surety is liable to the same extent as the debtor (for the payment of interest and penalty, compensation for damages), unless the contract of suretyship provides otherwise[31].

5.4.4 Guarantees

Lithuanian law provides for two types of guarantees: bank guarantees and guarantees issued by other legal entities. As a result the guarantee as a kind of security is regulated by (i) general rules applicable to all guarantees, and (ii) specific rules applicable only to bank guarantees.

The liability of the guarantor to the beneficiary indicated in guarantee is subsidiary (note that the guarantor is only liable against the beneficiary indicated in the guarantee) and is limited to the amount for which the guarantee was issued.[32] The obligation of the guarantor towards the beneficiary does not depend on the principal obligation, the performance of which is secured by it. A guarantee is an independent obligation even in the cases when the principal obligation is indicated in the guarantee.[33]

5.5 Transferability of collateral associated with a claim

5.5.1 General

Easy, efficient and non-costly assignment of collateral securing the assets is one of the core factors for successful covered bonds and securitisations in Lithuania. Following current regulation the transfer of certain types of collateral may be complicated due to certain limitations of the legal acts. Therefore, some amendment and alternative solutions would have to be developed for covered bonds and securitisations framework, e.g.:

- one-off action for re-registration of pool of assigned registered collateral instead of multiple and costly piece-by-piece re-registrations;
- carve-out in relation to obtaining consent of third party collateral provider or guarantor (including state guarantees).

In general under Lithuanian law all security interests are transferred to the new creditor together with the secured claim[34]. Consequently, as a general rule, the security interest should follow the transferred obligation, even despite the fact that the secured obligation is governed by other than Lithuanian law (provided that specific requirements (if any) applicable to the transfer of main obligation are observed).

However, due to conflicting rules or possible contractual restrictions, there may be additional requirements for transfer of security interest, such as:

- transfer of certain security interest registered with the public registers may need to be recorded in the respective registers;

[30] Part 2 of Article 6.76 of the Civil Code
[31] Part 3 of Article 6.78 of the Civil Code
[32] Part 1 of Article 6.92 of the Civil Code
[33] Part 2 of Article 6.90 of the Civil Code
[34] Part 2 of Article 6.101 of the Civil Code

- where the security interest is granted by the third party, a consent of such third party may be required;
- security interest agreement and/or the secured agreement may include or may be interpreted as including provision limiting and/or restricting the transfer of rights and obligations.

5.5.2 Transfer of mortgage or pledge

As mentioned in sections 5.3.1 "*Assignment of claim*" above, in case of assignment of claim secured by (i) possessory pledge, such assignment may be used against third parties once the possession of the object of the pledge is transferred to the new creditor; (ii) the registered mortgage or by registered pledge, such assignment would be valid as of the respective date indicated in the assignment agreement. However, in case of the latter, assignment may be used against third parties acting in good faith once the assignment is registered with the Mortgage Register[35]. Consequently, the following actions may be required:

- signing of assignment agreement or an application to the notary requesting to make entries to the Mortgage Register;
- the consent of the owner of the security object in case of third party mortgage/ pledge (in Lithuanian – *svetimo daikto įkeitimas/ hipoteka*) may be required (if such consent is not foreseen in the agreement).

The amendments in the entries of the Mortgage Register are not automatic and currently there is no possibility to re-register the pool of registered securities based on one asset transfer agreement, i.e. re-registration must be done under piece-by-piece basis.

5.5.3 Guarantees

As mentioned above, the law provides for two types of guarantees: bank guarantees and guarantees issued by other legal entities. Where the bank guarantee does not have transferability provisions, transfer of such guarantee would require a prior consent of the guarantor. The law does not provide for a specific limitation to transfer the claim secured by the guarantee issued by other than a bank legal entity, and as a general rule, the security interest should follow the transferred obligation.

Further, the transfer may have practical risks in particular cases where assets are secured by state funds' guarantees, e.g. guarantees issued by UAB "Investicijų ir verslo garantijos"), the Ministry of Finance of the Republic of Lithuania or Lietuvos valstybinis mokslo ir studijų fondas or UAB ŽEMĖS ŪKIO PASKOLŲ GARANTIJŲ FONDAS. Transfer of the rights under guarantee issued by these state funds may be restricted. If the issued guarantee does not provide for consent to the assignment, there is a risk that the security granted thereby would not transfer to the assignee and thus may be lost. In addition, please note that the law may be interpreted so that only a credit institution may become a beneficiary under a guarantee issued by any of these state funds.

The above limitations do not favour the smooth transfer of security backing the assets, therefore, considering that the mere change of the beneficiary does not actually affect credit risk taken by the guarantor, it is advisable in securitisation framework to remove consent requirements in case of transfer of the assets secured by the guarantees to the SPV.

[35] Part 4 of Article4.189 of the Civil Code, Part 2 of Article 4.223 of the Civil Code

5.5.4 Surety

The Civil Code does not establish any special rules for transferability of claims secured by the surety, and as a general rule, the security interest should follow the transferred obligation.

5.6 Security trustee

For the purpose of covered bond and securitisation frameworks, specific adjustments introducing a clear concept of security trustee able to hold security in its own name (where individual creditor's rights once the trustee is appointed are suspended) are needed. This would enable to more efficiently exercise the creditors' rights and administer the pool of assets.

Generally note neither the concept of the security agent nor other legal concepts in Lithuanian law cover usage or specifics of a trust (as it is understood in common law) as the holder of security on behalf of other beneficiaries.

However, some provisions of Lithuanian law briefly indicating such an institute give a legal ground for feasibility of the latter, i.e. (i) provisions of the FCA Law stipulating that financial collateral arrangement might be concluded by the person acting in trust or representative capacity on behalf of the institutions being eligible counterparties to financial collateral agreements, (ii) provisions of the Civil Code establishing that in cases where the interests of several creditors are represented by one representative upon the written agreement of the creditors there might be indicated in the pledge/mortgage agreement that representative (irrespective of whether such agent is one of creditors or only represents all other creditors) of the creditors in the Mortgage Register they shall be disclosed as the creditor[36]. In such case either of general provisions regulating agency relationships[37] (in Lithuanian – *atstovavimas*), mandate relationships[38] (in Lithuanian – *pavedimas*), trust of property (in Lithuanian – *turto patikėjimas*[39]), administration of property owned by others[40] (in Lithuanian – *kito asmens turto administravimas*) shall apply, as the case may be.

5.7 Impact of the issuer's insolvency on the pool of assets

In order to enable the on-going servicing of the pledged assets and further continuance of the securitisation or covered bond program, the following carve-outs from insolvency laws (the Bankruptcy Law or Restructuring law) are needed, i.e. upon the issuer's insolvency:

- no recovery from the pool of assets may be allowed, instead, pool of assets have to be clearly separated from the insolvency estate and further servicing of program have to be ensured following special provisions of law;
- no arrangements of the creditors have to be made in respect of the cover pool; restructuring proceedings initiated against the issuer, may in no way affect it;
- no acceleration of debtors' obligations, receivables wherefrom comprise the cover pool– those assets have to be separated from the insolvency estate and serviced separately;

[36] Part 4 of Article 4.186 and Part 3 of Article 4.210 of the Civil Code
[37] Articles 2.132 – 2.151 of the Civil Code
[38] Articles 6.756 – 7.765 of the Civil Code
[39] Articles 4.106 – 4.110, 6.953 – 6.968 of the Civil Code
[40] Articles 4.236 – 4.252 of the Civil Code

- no petition rights for investors to claim from the pool of assets;
- all restrictions to further fulfilment of outstanding and not fully performed issuer's obligations (including calculation and payment of interests, default interest etc.) with regard to covered bonds and securitisations shall not be applicable;
- no discretion for bankruptcy administrator (or creditors in case of restructuring) as to further continuance of any covered bonds or securitisation transaction agreements; special solution of further continuance, transfer (if needed) and servicing thereof upon liquidation of the issuer have to be developed;
- no review and challenging by the bankruptcy administrator of covered bonds or securitisation documents;
- no right for other creditors of insolvent issuer to challenge covered bonds or securitisation documentation.

Lithuanian laws distinguish two types of procedures – bankruptcy and restructuring. While both procedures grant corporate entities certain protection from their creditors, the procedures and their purpose are different[41].

Bankruptcy proceedings, both judicial and extrajudicial, primarily aim at the maximum reduction of a company's debts by way of sale of assets and subsequent liquidation of a bankrupt company (though during bankruptcy proceedings a company may continue its activities and may enter into settlement agreement with its creditors until the moment it is declared bankrupt by the court).

The restructuring proceedings aim at allowing companies with financial difficulties and which have not yet discontinued their economic and commercial activities to maintain and develop these activities, settle their debts and avoid bankruptcy with the help of the creditors.

Upon initiation of insolvency proceedings the financial collateral covered by the FCA Law would take effect in accordance with the terms of the financial collateral arrangement, as the FCA Law is superior to laws governing insolvency proceedings. In the event the pledge is not covered by the FCA Law, respective rights of the pledgee shall be enforced according to the Bankruptcy Law.

In bankruptcy proceedings claims of all creditors, irrespective of whether the claims are secured or not, must be satisfied in accordance with the procedure established by law. Thus, after the initiation of the bankruptcy, the secured creditor will not be able to unilaterally enforce the security but will have to follow the procedures provided for in the bankruptcy laws.

The secured party will have a priority to recover from the collateral: either (i) from the proceeds obtained from the sale of the collateral or (ii) by the way of transfer, the collateral to the secured party in accordance with the established procedure. Unsatisfied amounts of the secured claim will be satisfied in accordance with the general rules on creditors' ranking. Sale of assets of the mortgagor or pledgor will be organised by the bankruptcy administrator that has to follow resolutions of the creditors' meeting.

Further, the Bankruptcy Law clearly indicates that all terms of the payment obligations of the entity under bankruptcy from the day of the formal initiation of the bankruptcy proceedings (in Lithuanian

[41] For the purposes of this analysis, by term "insolvency proceedings" we will refer to both the bankruptcy and restructuring proceedings, unless from context it is clear that the reference is made to only one of the proceedings.

– *bankroto bylos iškėlimas*) shall be considered to have expired. Consequentially, all the creditors of the entity are allowed to submit their creditor's claims to the bankruptcy administrator[42].

The Bankruptcy law clearly indicates that upon opening of the formal bankruptcy proceedings it is prohibited to fulfil all outstanding and not fully performed obligations of the insolvent company, including payment of interest, default interest, taxes, fees and other mandatory contributions, as well as to recover debts from the property of insolvent entity[43] . Calculation of any type of interest and default interest payable by the insolvent entity is also terminated as of the formal opening of insolvency proceedings.

Notably, the bankruptcy administrator appointed upon the opening of formal bankruptcy proceedings against any issuer in bankruptcy (in Lithuanian - *bankroto bylos iškėlimas*) would be entitled to elect at its discretion and on behalf of the estate of such issuer whether: (i) to reject performance of any not fully performed contract of the issuer; or (ii) to perform such contract[44].

Finally, under the Bankruptcy Law a bankruptcy administrator examines the contracts of the insolvent entity entered into by it at least 36 month prior to the opening of bankruptcy proceedings and brings actions to invalidate these contracts if they contradict the objectives of the company and (or) may have caused the company to not be able to settle with its creditors[45]. Should the bankruptcy administrator determine features of intentional bankruptcy and the court declare the bankruptcy intentional, the bankruptcy administrator shall examine all the contracts of the company concluded 5 years prior to the initiation of the bankruptcy proceedings[46].

It should also be mentioned that not only the bankruptcy administrator but each creditor individually shall have the right to challenge transactions concluded by the insolvent company on the basis of *actio Pauliana* where the creditor deems that the insolvent company was not obliged to conclude the respective contract and such a contract violates the rights of the creditor, while the insolvent company knew or ought to have known that the creditor's rights would be prejudiced (Article 6.66 of the Civil Code). A transaction is deemed as violating a creditor's rights where: (i) the company becomes insolvent due to such transaction, (ii) the company, being insolvent, grants preference to another creditor or (iii) creditor's rights are infringed in any other way.

As regards restructuring proceedings, they also grant to the issuer protection from its creditors. Terms and conditions of the settlement with the creditors (including secured creditors) must be determined in the restructuring plan (that is approved by the creditors) which must comply with rules set out in law. Hence, similar carve-outs are needed for covered bonds and securitisation purposes.

5.8 Debtor's right to set-off in case of insolvency of the issuer

Prohibition of the rights of set-off against cover pool is in line with the securitisations. However, this has to be a general rule, applicable not only upon insolvency of the issuer.

[42] Clause 5 of part 4 of Article 10 of the Bankruptcy Law
[43] Clause 2 of part 7 of Article 9
[44] Clause 4 of part 7 of Article 10 and clause 13 of part 1 of Article 11 of the Bankruptcy Law
[45] Clause 8 of part 5 of Article 11 of the Bankruptcy Law
[46] Part 5 of Article 20 of the Bankruptcy Law

Both the Bankruptcy Law and the Restructuring Law prohibit set-off of claims in case of insolvency proceedings (except set-off of specific claims allowed pursuant to respective tax laws, also set-off derived from the certain EU legal acts, e.g. financial collateral arrangements covered by the FCA Law).

5.9 Preliminary Proceedings

The following carve-outs are needed with regard to securitisations and covered bonds programs:

- no interim measures (including restrictions on disposals) may be applicable with regard to cover assets and powers, no limitation, suspension of mandate of special administrator servicing the pool of assets upon issuer's insolvency; this should be made the general rule both upon issuer's insolvency and absence thereof;
- collection of receivables by special administrator (security trustee) and their transfer to investors when needed may not be suspended or otherwise negatively affected either;
- no limitations of the issuer's (commercial) activity related to servicing of the covered pool;
- no re-direction, transfer of receivables into a single account where all funds from the commercial activity of the insolvent entity are accumulated (all receivables comprising covered assets have to be fully legally segregated from insolvency estate, and hence, any possibility to comingle receivables for settlement with secured and unsecured creditors should be avoided; ideally receivables comprising covered assets have to be accumulated in a separate account(s) dedicated to satisfy exclusively the interest of secured creditors (investors));
- no insolvency related fees may be deducted from the pool of cover assets, i.e. investors do not finance bankruptcy, restructuring proceedings and liquidation of the issuer.

Upon the filing of an application for opening of formal insolvency proceedings and prior to the opening thereof, the court may order interim measures pursuant to the Bankruptcy Law[47]. The court may on its own initiative or upon request of the creditor apply any of interim measures indicated in the Civil Procedure Code. Moreover, if any enforcement proceedings with respect to the property of insolvent entity were started, pursuant to the Law on Bankruptcy all enforcement proceedings are stayed (Part 3 of Article 9) and it is only allowed to seize the property while realisation and recovery from the seized property is suspended.

In addition, upon commencement of the formal insolvency proceedings (in Lithuanian – *bankroto bylos iškėlimas*) the Bankruptcy Law enables the court upon the creditor's request to withdraw the insolvent entity's right to dispose of the assets without the court permission or establish restrictions over the commercial activities of the insolvent entity[48]. Notably, the Law on Bankruptcy allows the insolvent company to pursue commercial activity provided that the result of such activity reduces losses recorded in the balance sheet of the entity. It is also allowed to deduct the expenses related to such activity from the proceeds received from such activity. The law establish a requirement that all payments related to permitted commercial activity of the insolvent entity were processed through a single account designated for settlements related to such commercial activity and which

[47] Clause 5 of Part 2 of Article 9 of the Bankruptcy Law
[48] Clause 6 of the Part 7 of Article 9 of the Bankruptcy Law

must not be used for settlement with the creditors of insolvent company according the Bankruptcy Law .

5.10 Bond issuance- creating the securities

There is a need to introduce a clear concept of private placement and achieve a legal certainty related to the distinction between private placement and public offer.

Each type of issue (e.g. private placement and public offering) is specifically regulated, and is subject to separate procedures scattered within three legal acts: the Companies Law, the Law on Securities and the Law on Protection of Bondholders[49]. The types of distribution may be split into the following categories each triggering different placement and documentation requirements:

(i) Public offer

Pursuant to the Law on Securities, public offer means a communication to persons in any form and by any means offering securities and presenting sufficient information on the terms of the offer and the securities to be offered so as to enable an investor to decide to purchase or subscribe to these securities. Offering of securities through intermediaries of public trading in securities shall also be deemed public offering provided it meets the features of the public offering. Communication to persons via the regulated market of the Republic of Lithuania is not deemed to be a public offering of securities. For the public offer of securities the issuer must prepare and publish a prospectus (offering documents with detailed requirements) unless the offer falls under exemptions which discharge the issuer from said obligations.

(ii) Exemptions from prospectus requirement

The Law on Securities provides the exemptions from the requirement to prepare and publish prospectuses. The Bank of Lithuania seems to unofficially uphold that the exemptions to publish prospectus may be in a way regarded as a private placement. These exemptions are brought from the Prospectus Directive into the national law, hence not elaborated below.

(iii) Public offering of medium size issues: no need of prospectus

When the total sale value of securities exceeds EUR 100,000 but is less than EUR 5 million over the 12 months period and such public offer does not fall under regulations of securities markets[50] the issuer must prepare and publish an information document instead of a prospectus. Nonetheless, the information document is not needed where securities offered and the offer meets any of the Securities Law exemptions from the requirement to prepare and publish the prospectus.

The regulator – the Bank of Lithuania – is involved in the issuance process only in cases when the issue is related to the public offering. As regards the information document to be prepared for the medium sized issues, the Bank of Lithuania is not participating in the process and is not responsible for the supervision of fulfilment of the requirements with regard to the information document, however it adopts a secondary legislation (Resolution on Medium Size Issues) stipulating requirements for the information document. Notably, the latest amendments to the said Resolution on Medium Size Issues has come into force as of 1 November 2016, however, it was not tailored for issues using SPV structures (e.g. requirements for disclosure of information regarding the issuer are made assuming that the issuer is an operating company).

[49] The Law on Mortgage Bonds is a special law which in addition to the general procedures of issuance set forth in the Companies Law and the Law on Securities specifically regulates the issuance of the mortgaged bonds.
[50] Part 2 of Article 78 of the Companies Law, Resolution on Medium Size Issues.

The following table summarises the interaction of requirements stemming from the Companies Law, the Law on Securities and the new Law on Protection of Bondholders:

Type No.	Type of offer	Prospectus requirements	Information document requirement	Bondholders' trustee requirement
Type 1	Public offer	Mandatory	N/A	Mandatory
Type 2	Exemptions:	-	-	-
	(i) securities are offered to qualified investors only	N/A	N/A	Optional
	(ii) securities are offered to less than 150 retail investors in each EU member state (excluding professionals)	N/A	N/A	Optional
	(iii) each investor has acquired securities for more than EUR 100,000 per each offer	N/A	N/A	Optional
	(iv) securities under offer are with the nominal value at least of EUR 100,000	N/A	N/A (unless	Optional
	(v) total sale price of all securities offered in member states does not exceed EUR 100,000 over 12 months period.	N/A	N/A	Optional
Type 3	Public offering of medium size issues (total sale value exceeds EUR 100,000 bust is less than EUR 5 million over 12 months period)	N/A	Mandatory (unless exemptions)	Optional

5.11 Tax neutrality

5.11.1 Transfer of the assets to the SPV

We believe that improvements to the rules on the deductibility of losses incurred upon the sale of claim rights are necessary to reach a tax efficient securitisation framework. In particular, a transfer should not result is non-deductibility of losses for corporate income tax purposes for an originator. The Law on Corporate Income Tax and the Commentary to the Law on Corporate Income Tax should be changed for this to be achieved.

Corporate income tax

Any profit earned by an originator with taxable presence in Lithuania is taxable with corporate income tax ("**CIT**") at the time of transfer. An originator's loss resulting from the transfer of claims is in general treated as non-deductible expense for CIT purposes (as extraordinary business expenses), unless transfer of claims is deemed to be an ordinary activity of an originator. An originator cannot enjoy bad debt relief either for CIT or VAT purposes with respect to transferred claims.

Value added tax

Supplies of goods and services are in general subject to value added tax (the "**VAT**") unless specific exemptions and exceptions apply (provided that the place of supply is Lithuania). Under the official commentary to the Law on VAT, all transfers of claim rights are treated as being outside of the scope of VAT. Nevertheless, if such claims are transferred by way of entering into a factoring agreement with SPV, any SPV (factor's) remuneration is subject to VAT at a standard rate of 21%, as the financial services exemption does not apply. A business transfer is not subject to VAT under Article 9(1) of the Law on VAT.

5.11.2 Taxation of an SPV

National legal rules should ensure that no tax is levied at the level of an SPV by allowing extraction of SPV's profit by an originator in a tax neutral way and taxation of this profit at originator's level only, which is the general principle with respect to ABS and covered bonds structures.

As a general principle, no new tax liability should be created and no existing tax liability avoided.

Lithuania's double tax treaty network should be extended and existing treaty benefits improved to minimise foreign tax exposure on SPV's foreign sourced income.

Corporate income tax

Any SPV acting in the form of either a private or public limited liability company established in Lithuania is fully liable to CIT. This tax is levied on the net accounting profit (gross profit minus deductible expenses) calculated on an accrual basis. An SPV's deductible expenses are, in general, any expenses that relate to the common day to day activities of an SPV incurred for the purpose of earning income or deriving economic benefit, including the following: (a) interest paid to bondholders; (b) premiums, interest and other payments relating to funds borrowed, except interest paid to a controlling borrower[51] where interest rate is linked to a debtor's profitability, turnover or similar criteria and where a creditor has a right to exchange his right to interest to a right to a debtor's profit; (c) any expenditure incurred in respect of the day to day administration of the assets; (d) expenses relating to credit enhancement measures etc. This allows ensuring that, pursuant to the general securitisation practice, essentially no or very little taxable profit is generated at the level of an SPV. Additional legal certainty is, however, needed with respect to the tax deductibility of losses resulting from the acquired claims. In particular, general bad debt relief rules would not apply to an SPV in the event of default of debtors as these rules are only applicable in situations where a receivable amount has been included into taxable income for CIT purposes and where output VAT has been charged and reported for VAT purposes (Article 25 of the Law on CIT and Article 89[1] of the Law on VAT. Therefore, additional clarity is necessary with respect to entitlement of an SPV to write off an acquired claim right and recognise deductible expenses for CIT purposes.

The standard CIT rate is 15%. A reduced 5% CIT rate applies where income does not exceed EUR 300,000 and the average number of employees does not exceed 10 (additional conditions may apply).

An SPV can reduce or eliminate foreign tax exposure of debtors' payments on the basis of the Lithuania's double tax treaty network. Currently there are 53 treaties in place. Nevertheless, only three of the currently valid treaties reduce the withholding tax on interest to zero[52], whereas others allow reduction of the withholding tax to 10% only. Therefore, improvement of the treaty benefits is necessary.

Value added tax

The creation and issuance of securities is not subject to VAT or exempt from VAT (28(5) of the Law on VAT). Transactions in securities (including bonds), dealings in credit guarantees or any other security for money are exempt from VAT. There are some exceptions (Articles 28(2) and 28(5) of the Law on VAT).

[51] An entity is controlling where it owns more than 50% of the shares of the SPV or owns more than 50% of the shares of the SPV together with associated persons and the creditor's own holding is not less than 10%. Member of a group of entities is also treated as a controlling entity.

[52] Treaties with Cyprus, Latvia and **United Arab Emirates**.

As an SPV engages in wholly or mainly non-taxable or exempt activities, an SPV would have a limited right to deduct any input VAT incurred on the acquisition of goods and services subject to VAT (e.g. servicing).

5.11.3 Profit extraction from the SPV

As a general rule, no taxable profit is generated at the level of SPV as all profit is extracted in different ways by an originator and taxed at the originator level only. Profit extraction and credit enhancement methods in use should ensure tax neutrality at the level of an SPV, including in the form of non-deductible expenses.

As thin capitalisation restriction can impede tax neutral financing of an SPV, an exception could be created for securitisation vehicles meeting certain criteria.

Exemption of servicing from VAT is necessary and should be ensured in so far that the European VAT Directive framework allows an exemption. Legal certainty on the scope of different VAT exemptions with respect to ABS and covered bonds is necessary.

Subordinated loan; originator holding junior tranche bonds

Any interest paid by an SPV to an originator would constitute a deductible expense for an SPV and taxable income for an originator with taxable presence in Lithuania. Any interest paid to originators established within the European Economic Area or a country with which Lithuania has an effective double tax treaty would be exempt from withholding tax in Lithuania. All other interest payments would be subject to a 10% withholding tax.

Thin capitalisation restrictions (a debt-to-equity ratio of 4:1) should be respected where an originator is an SPV's controlling entity. Failure to meet this debt-to-equity ratio would result in interest attributed to the debt in excess of the ratio being non-deductible for an SPV, unless it is proven that the same loan would have been granted under exactly the same conditions by an unrelated party (which is rather difficult to prove in practice). For the thin capitalisation rule not to impede tax efficient financing of an SPV, legal acts could exempt securitisation vehicles from thin capitalisation restriction[53]. Furthermore, transfer pricing requirements would apply where an originator and an SPV are associated entities (risk of interest non-deductibility for an SPV).

The granting and negotiation of credit and transactions in securities are in general exempt from VAT under Articles 28(1) and 28(5) of the Law on VAT.

Deferred purchase price payments for assets

There are no legal rules under which the deferred price should be treated as interest for tax purposes and would thus be subject to withholding tax at source.

Servicing fees

Servicing fees would be deductible for an SPV and attributed to taxable income of an originator with taxable presence in Lithuania. Transfer pricing requirements would apply where an SPV and a servicer are associated entities.

There is no specific VAT exemption for servicing with respect to ABS and covered bonds. Depending on the asset type, servicing could either be exempt from VAT, or subject to VAT at a standard rate of

[53] Under the current rules, thin capitalisation restriction already does not apply to entities engaged in financial leasing activities.

21% (provided that the place of supply is Lithuania). For example, a credit management exemption could potentially apply with respect to credit receivables (Article 28(1) of the Law on VAT). This may only apply to servicing performed by an originator who granted the credit but not a third party. Additional legal certainty is necessary with respect to the application of this and other VAT exemptions with respect to ABS and covered bonds, i.e. laws should state that no VAT on servicing is applied to the extent this is in line with the European VAT Directive.

Dividends

Dividends are non-deductible for an SPV. Dividends are subject to 15% withholding tax at source (including domestic payments). Some double tax treaties reduce the withholding tax rate to 10%, **5% or 0%**". A domestic law exemption from withholding tax applies in such situations where an originator holds no less than 10% of an SPV's share capital and this holding lasts or will last after the distribution for not less than 12 months (not applicable to black listed jurisdictions). A Lithuanian tax resident originator can off-set the withholding tax against the annual profit tax and thus effectively reduce the dividends' tax burden to zero.

5.11.4 Bond issuance

Domestic law exemption from withholding tax on interest paid to non-Lithuanian resident corporate investors could be extended to apply to all interest payments, except payments to black listed territories.

Domestic law exemption from withholding tax on interest paid to non-Lithuanian resident individual investors could be introduced in order to encourage foreign investments.

Value added tax

Creation and issuance of securities, including bonds, is not subject to VAT, or exempt from VAT (28(5) of the Law on VAT). Dealings in securities are ex empt from VAT. There are some exceptions (Article 28(5) of the Law on VAT).

Income taxes

Taxation of interest sourced in Lithuania depends on the tax residency and form (legal entities or individuals) of a recipient:

- Interest earned by Lithuanian tax resident legal entities and individuals is generally subject to 15% CIT and 15% personal income tax respectively;
- Interest earned by non-Lithuanian resident entities established or otherwise registered in a country that is a member of the European Economic Area or a country with which Lithuania has entered into an effective double tax treaty is exempt from withholding tax in Lithuania. Other interest is subject to 10% withholding tax.
- Interest earned by non-Lithuanian resident individuals is subject to 15% withholding tax in Lithuania, unless a particular double tax treaty provides for a reduced withholding tax rate or an exemption.

5.12 Cross-border issues

The above comments are specific to transactions undertaken in Lithuania and secured on Lithuanian assets. However, as noted in section 6 it is likely that several banking entities that might wish to use the proposed law would have a strong economic incentive to also use assets in other countries including, but not limited to, Estonia and Latvia.

Some of the above discussed topics are not materially affected by the location of the assets. For example, the establishment of the SPV, bond issuance and insolvency are purely and taxation – to a large extent domestic Lithuanian matters. Other topics in the law can easily accommodate foreign assets.

There are, however, some specific implications of the use of non-Lithuanian assets that should be considered.

Asset transfer mechanics

The way in which the underlying assets and ancillary rights are transferred to the special purpose vehicle and the attendant practicalities (for example, the necessary amendments to the land registry) will naturally be entirely a matter for the law of the country of origin of the assets. Whereas we are confident that a valid transfer can be achieved in several jurisdictions it is not practical at this stage to speculate on which jurisdictions and methods of transfer will achieve the commercial objectives of possible users of the law.

Insolvency procedures and enforcement of claims

Whichever jurisdictions are used and whatever method of transfer is chosen, it will be necessary to ensure that local insolvency and resolution procedures do not interfere in the timely exercise of the SPV's rights against the assets. For example, an insolvency court should not be able to impose a stay on the exercise of security.

It should be noted that the bank recovery and resolution directive (article 44 2(b)) explicitly exempts covered bond liabilities from bail-in. Lithuania is bound by the European Council Regulation EC No 44/2001 of 22 December 2000 (**Brussels Regulation**). As a result of Brussels Regulation, judgment obtained in a Lithuanian court is enforceable in other Member States.

We would propose that the law restricts assets in cover pools to those countries

- where it is clear that the preferential right of covered bond creditors to the assets is legally valid and enforceable. The German Pfandbrief law includes such a concept (although it also allows a 10% exemption to this rule), and
- where the Bank Recovery and Resolution Directive has been fully transposed into national law.

Banking supervision

The supervision of potential issuers of covered bonds who operate in Lithuania through branches rather than regulated subsidiaries may be problematic in practice. In particular it would require the establishment of a new supervisory relationship by Lithuanian authorities who may find it onerous to, for example, grant a covered bond issuance license to a bank who they did not previously regulate. Enforcement and penalty rules in the secondary covered bond regulations will require the Lithuanian regulator to serve an enforcement notice to a foreign entity.

Furthermore there is a potential conflict of interests between the Lithuanian regulator's duty of care towards covered bond holders and the foreign regulator's more general obligations. This may manifest, for example, in disputes over the necessary level of over-collateralisation to be included in the pool.

It may be necessary to limit the right of issuance to banks who are currently regulated in Lithuania. This could be achieved by (currently) non-Lithuanian banks by, for example, the establishment of

a guaranteed funding subsidiary ("TreasuryCo") of the existing Operating Company ("OpCo"). The funding subsidiary could be considered to be a Lithuanian bank for these purposes.

Further consideration of this point by all stakeholders is requested.

Secondary regulations

There are many practical issues in the secondary regulations that will need to reflect national specificities. For example, secondary rules normally specify the rules for the valuation of the underlying security and loan-to-value ratios. Each country has its own most appropriate way to arrive at these values and the secondary regulations will need to reflect this in each country that might be considered.

As these rules are included in secondary regulations rather than a primary act of the Lithuanian parliament it will be relatively easy to amend them as and when required.

5.13 Lithuania as attractive market place

As already indicated in previous sections, in order to have Lithuania as attractive market place flexible and robust legal, regulatory and tax framework has to be in place. We consider the following as core factors incentivising securitisations in Lithuania:

I. Favourable and steady tax regime:

- tax neutrality is one of the key advantages of covered bonds and securitisation transactions. High level of certainty in relation to the issuer's tax position is also cautiously considered by rating agencies when granting rating to securities; any unexpected tax charges against the issuer would prevent good rating of securities and, hence impede securitisations and covered bonds;
- extension of double tax treaty network;
- exemption from withholding tax on payments to investors.

II. Enhanced investor protection:

There should be no limitations as to investor base, hence:

- bankruptcy remoteness principle enabling separate the cover pool from insolvency risks of the originator, SPV, servicer or other involved parties has to be ensured. The SPV needs to have a right to claim the transfer of ownership of cover pool (if needed) and any cash collected on its behalf in case of insolvency proceedings of related parties;
- the law shall recognise validity and enforceability of contractual provisions that aim to protect SPV from individual claims of creditors, namely:
    - subordination provision allowing investors and other creditors to subordinate their claims as envisaged per transaction structure – this is crucial for tranching the transaction;
    - non-petition provision for investors – this will protect the SPV from actions of individual investors to initiate insolvency proceedings against the SPV;
    - non-recourse provision allowing investors to waive their right to request enforcement (e.g. in case of temporary or well-known situations);

- there should be viable and effective security trustee/agent institute.

III. Simple and cheap liquidation procedures of the SPV as transaction matures.

IV. Possibility to pool the assets (e.g. receivables from different Baltic countries) should be upheld by law at least by (i) setting no implications for cross-border transfer domestically, (ii) making regulatory and tax regime friendly.

V. Limits on investments of institutional investors (pension funds, insurance companies) should be removed (or significantly reduced) to the extent that the new law and bond transactions resulting from it are able to demonstrate to a satisfactory level that they have improved the credit-worthiness and thus the appropriateness of investments:

  - Currently Lithuanian law establishes a maximum 10 % exposure on investments into securities of one issuer, however this limit does not apply in relation to transferable securities or money market instruments issued or guaranteed by government or municipality. We consider that pension funds regulation should treat cover bonds/securitisations more favourably if their credit rating is both higher and materially de-linked from the unsecured credit standing of that issuer;

  - Upon introduction of Solvency II regulation as of 1 January 2016 securitisation vehicle may become even more attractive for insurers and re-insurers. It could happen so that some equity-type investments could be less attractive in comparison to debt products with the same underlying assets as this may require the lower capital at the insurer's side. However, currently insurers are subject to certain limitations on their investments, which should be reconsidered to incentivise upcoming securitisation and covered bond framework. Solvency 2 specifies certain criteria for investments to qualify for preferential treatment. These will need to be met by any new Lithuanian covered bonds or securitisations in order to benefit from this treatment.

6. Economics of proposed products

6.1 Cost and benefits of secured funding

Covered bonds would represent the economically most effective form of term funding for Lithuanian banks in terms of the yield that must be paid to investors, the maturities that would be available and the most robust market access in stress scenarios.

However there are two potential drawbacks. Firstly there is no significant pressure for term funding currently for Lithuanian banks albeit for reasons which are unlikely to persist in the long term. Secondly, the upfront costs of establishing a programme – both internal and external - will be higher than for senior unsecured bonds. Covered bonds that can accept assets also from Latvia and Estonia would reduce this problem to the extent that the upfront costs could be amortised over a greater potential issuance volume.

Securitisations have the potential to also generate a cost saving for Lithuanian banks although this is likely to be lower than the saving available via the covered bond market, is highly dependent on the regulation and subsequent development of the securitisation market and is highly dependent on the nature of the underlying assets securitised.

The extent that securitisations can reduce the necessary level of regulatory capital for banks will largely depend on the risk retention rules in the STS securitisation directive which are currently being developed by Commission, Parliament and Council in the trilogue process.

Securitisations can reduce the cost of funding for non-bank entities in Lithuania, potentially significantly. The extent of the saving is of course highly dependent on the nature of the underlying assets.

6.2 Economic benefits of secured funding

Any form of long term funding for a bank is normally more expensive than the funding that they achieve by short term deposits (in the absence of an inverted yield curve). However the total quantum of deposits in any given country is for all practical purposes a fixed amount therefore in total it is unable to fund an expansion of aggregate bank balance sheets. Furthermore deposits are highly price sensitive and likely to adversely react to negative credit developments for a bank – with potentially catastrophic consequences as has been seen in many European bank failures over the course of the financial crisis.

The appropriate comparator for covered bonds is therefore senior unsecured bonds issued by the same banks. Covered bonds compare favourably with these in three main ways:

- Cost of funding. Although it is too early to reliably estimate the lower interest cost for Lithuanian covered bonds, in general terms in the Euro zone covered bonds have tended to trade at spreads over the risk free rate (for example the yield on German government bonds) of between 40% and 50% of the spread for unsecured bonds of the same issuer. Currently this ratio is generally lower due to the effects of the European Central Bank's covered bond purchase programme.
- Term of funding. Covered bond investors welcome longer bond maturities than investors in senior unsecured debt. This is partially due to their higher credit rating and partially due to the higher participation of insurance and pension investors in the euro covered bond

markets (in part due to the favourable treatment of the product under Solvency 2). Ten year or longer bonds are common in the covered bond market.

- Access to funding in stress scenarios. Covered bonds are frequently the first private sector bonds to be issued after a severe financial shock, whether the shock is to the entire financial system (for example, after the default of Lehmans) or to that particular issuer (many 'rehabilitating' Portuguese, Spanish and Irish banks for example accessed the covered bond market before attempting unsecured bond issuance. This resilience is a function of both the higher credit rating of covered bonds and the 'real money' (i.e. unleveraged) nature of the majority of covered bond investors which implies that they have to invest proceeds from maturing bonds back into the market.

- The first two of these conditions also apply to securitisations although, as noted above, it is even more difficult to quantify the benefits in the absence of more concrete information on the asset classes and level of risk retention.

6.3 Current Funding Needs

There is little pressure currently for any form of term funding for Lithuanian banks. This is a combination of several factors, some of which are likely to persist in the medium term.

- **Reliance on parental funding**. Significant levels of funding are currently down-streamed or could be down-streamed from non-Lithuanian parent banks.

  The availability of this funding source is likely to diminish if there are divestments of Lithuanian banks, in response to (non-Lithuanian) regulatory pressure to reduce foreign exposure and as the credit quality (and therefore the cost of funds) of Lithuanian and parent banks continues to converge.

- **Reliance on deposit funding.** Several Lithuanian banks that the project team met with reported high levels of deposits relative to their loan books. As noted above this has the potential to generate risks to systemic stability.

- **Slow balance sheet growth.** Coupled with the above factor, the same banks reported that they had relatively low needs for new net funding due to slow growth in the asset side of their balance sheet.

- **Lack of regulatory pressure for term funding**. Despite the financial stability considerations there is currently little pressure on banks to better match asset and liability maturity profiles. This pressure can be of a 'soft' nature – a regulator recommendation that banks improve their access to term funding – or of a 'hard' nature, specifically via the Net Stable Funding Ratio. The current calibration of the NSFR is discriminatory towards covered bonds (due to a higher requirement for stable funding for encumbered mortgages), but we anticipate that this is likely to change in the near future.

6.4 Costs of issuance

The cost of issuing a covered bond is dependent on both the details of the regime chosen (for example the costs of compliance with the supervisory regime) and the strength of the covered bond, therefore the rating uplift that it provides, therefore the spread which will be required by investors.

Programme establishment

The primary external costs when establishing and maintain a covered bond programme are the legal costs, the rating agency costs and the costs of a cover pool monitor / auditor. The primary internal costs are management time and IT development.

Legal cost, depending on issuance, might be in the area of €20,000 - €50,000, and might be bigger if the foreign element requiring foreign law counsel is involved. Rating agency costs could be of the order of €100,000 to initially rate a programme plus an on-going annual fee of €40,000 plus 0.5 basis points for each rated bond issue. This assumes that the issuer is a subsidiary of a bank currently rated by the agency and that only one rating agency is engaged. A covered bond backed by assets in more than one jurisdiction may require additional costs. The cost of obtaining a rating for a senior unsecured issue for a bank with a rated parent would be likely to be of the order of €25,000.

Internal costs are of course issuer specific and difficult to quantify. However we would anticipate that the IT costs would be relatively low given the high quality of most Lithuanian bank's IT systems.

Management time will be marginally higher than for an unsecured bond (requiring for example the input of areas other than treasury and the regular compilation of more detailed reports on the cover pool).

Yield to investors

The yield that will be required on the debut Lithuanian covered bond is difficult to predict in the absence of further information (in particular regarding the degree of parental support for the issuer's credit rating, if any, and the rating uplift that the covered bond structure would support) and given that current funding conditions are largely affected by and depend on the current asset purchase programme of the Eurosystem, therefore it is highly unlikely to be the funding conditions that prevail when the debut issue is launched.

It is worth noting however that a new 5 year Lithuanian government bond would be likely to price at a level of mid-swaps plus 0.15% (according to an estimate provided by a leading investment bank), an all in yield of 0%. A debut covered bond could, assuming a high quality issuer and covered bond legal and supervisory regime, reasonably be expected to price at a small premium over this, according to the same investment bank mid-swaps +0.3 / 0.4% (an all-in-yield of 0.15% to 0.25%). This is broadly in line with the likely cost of unsecured debt for a typical well rated Scandinavian issuer currently.

The pricing of an unsecured bond by a Lithuanian bank is similarly difficult to estimate, in particular given how heavily dependent it is on the degree of parental support. On a standalone credit basis, that is assuming no parental support whatsoever, the only possibly meaningful recent benchmark transaction was a four year bond rated BBB/BBB by mBank of Poland which required a yield to investors of 1.398%, equivalent to 1.57% over mid-swaps.

7 Decisions needed, and next steps

7.1 Feedback from stakeholders

Prior to start drafting the law a feedback from the Ministry of Finance, the Bank of Lithuania and other stakeholders is sought. To the extent that the bonds produced are likely to be used as eligible collateral for open market operations at the ECB it will be a requirement that they are listed therefore feedback from the stock exchange in particular will be sought.

7.2 Laws

Under the Constitution of the Republic of Lithuania the Lithuanian Parliament (in Lithuanian - *Seimas*) is vested with power to adopt and pass primary legislation (the "**Laws**"). Each of the following has the legislative initiative powers:

- each member of the Parliament;
- the President of the Republic of Lithuania;
- the Government;
- the citizens of the Republic of Lithuania (50 thousand and more).

Notably, the Ministry of Finance of the Republic of Lithuania, based on its bylaws, is vested with the powers to prepare draft laws and other legal acts in a sphere of financial markets policy. Given that the initiative to develop the covered bonds and securitisation framework in Lithuania came from the Ministry of Finance, we would expect that the legislative proposal in relation to covered bonds and securitisation laws will be passed to the Parliament by the Government.

We consider that a special law on covered bonds and securitisations in Lithuania is needed as having a priority over the exiting legal acts addressing the similar relationships, e.g. the Civil Code, the Civil Procedure Code, the Financial Institutions Law, and the Law on Consumer Credit etc.

We suggest the form of the reform is introduction of a new law at the same time amending the existing legislation to be compliant with a new law on covered bonds and securitisations.

Secondary legislation to be passed on the basis of the covered bonds and securitisations law would be passed by the Bank of Lithuania.

7.3 Methods of incorporation of the new law into existing legislation

The new covered bonds and securitisation framework will impact a number of other Lithuanian laws. The possible techniques to incorporate the new framework into the existing legislation may be either of the following: (i) changing other laws by a specific provisions of covered bonds and securitisation law, (ii) passing a specific legislative act on changes to other laws; (iii) carving out a specific exception from application of a specific other law in case of covered bonds and securitisations, as the case may be.

We consider that either of those legal technics may be used dependent on the case, however, carve-out option is preferable one as allows to avoid a duplication and more easily address subsequent changes. Below are couple of examples illustrating this (dependent, however, on the position of the working group):

- the first option might be used extending supervisory functions of the Bank of Lithuania with regard to covered bonds and securitisations;

- second option may be used for supplementing provisions of the Civil Code by specific institutes relevant for securitisations and covered bonds (e.g. security trustee, transfer (assignment) of portfolio etc.);
- the third (carve-out) option may be useful adjusting insolvency laws to covered bonds and securitisation framework. For example, the Law on Bankruptcy establishes acceleration of all payment obligations of the company upon initiation of its bankruptcy proceedings. Hence, the Law on Bankruptcy could specifically prescribe that such acceleration is not applicable in case of covered bonds and securitisations.

In such a manner, a number of provisions of different legislative acts, in particular the Law on Bankruptcy, the Law on Restructuring, the Civil Procedure Code, the Law on Financial Institutions, the Law on Banks, the Law on Consumer Credit, the Law on Collective Investment Undertakings, the Law on Protection of Consumer Rights, would need to be limited in scope.

In certain cases, it may be recommendable to amend other laws for systemic reasons with a specifically targeted change. For example, the Law on Companies regulates requirements applicable to public and private limited liability companies (ABs and UABs), hence, specific amendments might be needed to address specifics of SPVs intended for covered bonds and securitisations. Further, the Civil Code regulates creation and transfer of collateral, as well as transfer (assignment) of claim itself. Depending on the approach taken by the working group, the Civil Code might need to be supplemented with (i) rules regulating status of security trustee enabling in its own name to represent multiple creditors, as well as rules allowing a more simple transfer of registered collateral tailored for transfer of pool of assets (e.g. waiver of consents, one-off re-registration of the whole pool of collateral) or (ii) rules introducing concept of transfer (assignment) of pool of assets (portfolios) having some universal features attributable to business transfer (public notifications, universal assignment), however, tailored to covered bonds and securitisation specifics and allowing transfer (assignment) of smaller pieces of business (not only substantial part thereof).

Based on the decisions made with respect to topics discussed in this study, other laws might need to be changed as well. For example, if the Bank of Lithuania is granted certain authorisations (to supervise, register or administer covered bonds or securitisations), corresponding laws setting up functions and powers of the Bank of Lithuanian might need to be changed as well (the Law on Bank of Lithuania, the Law on Markets in Financial Instruments etc.).

Appendix 1: European Banking Authority 'Best Practice' recommendations for covered bonds

The below represents a brief summary of the main recommendations. Further details are available at
www.eba.europa.eu/documents/10180/534414/EBA+Report+on+EU+Covered+Bond+Frameworks+and+Capital+Treatment.pdf.

1. **Dual recourse** Covered bond investors should have full recourse to both the issuer of the bonds (or their insolvency estate on a pari passu basis with other creditors) and to the assets in the cover pool.
2. **A. Segregation of the Cover Assets.** Assets in the cover pool should be sufficiently segregated and identified. The segregation must be legally binding and enforceable. This should include primary and substitute assets and derivatives

   B&C. Bankruptcy remoteness Payment obligations under the bond should not automatically accelerate in the event of the issuer's default. Insolvency processes should give priority to covered bond investor's claim over the cover pool. The insolvency administrator should be able to take all actions necessary for the realisation of the interests of the covered bond investor
3. **Cover Pools** The composition of cover pools should not materially change through the life of the covered bond. Cover pools should be generally limited to assets located in the EEA [or, for mortgage assets] the priority claim is legally enforceable in the jurisdiction under consideration.
4. **LTV limits** The framework should establish maximum loan-to-value limits for assets and standards for monitoring and evaluating the value of the property
5. **Coverage and over-collateralisation** All of the liabilities of the programme including liabilities towards derivative counterparties should be covered by assets. There should be a legal/regulatory minimum over-collateralisation level.
6. **A. Derivatives** Derivatives should be allowed exclusively for risk hedging purposes and should not be terminated upon issuer insolvency.

   B. Liquidity Liquidity risks should be mitigated by means of liquid assets available at all times to cover net out-flows

   C. Stress Testing Issuers should carry out stress test exercises on the calculation of the coverage requirement.

7. **Cover Pool Monitor** A cover pool monitor should be appointed other than the issuer's auditor. The regulations should specify the monitor's main responsibilities including the monitoring of all coverage requirements and eligibility tests and the random auditing of the cover pool.

   B. Supervision The competent authority should approve the establishment of a covered bond programme. They should be satisfied that there are adequate operational policies, procedures and controls, the restrictions applicable to an issuer are met and that the cover pool meets the applicable requirements.

C. Duties of National Authority in Issuer Insolvency The covered bond framework should provide sufficiently detailed description of the duties and powers of the competent authority are in a scenario of issuer default.

8. **Scope and Frequency of disclosure**. Covered bond issuers should disclose aggregate data on the credit risk, market risk and liquidity risk characteristics of the programme and other relevant information including concerning the counterparties involved and the levels of contractual and voluntary over-collateralisation on at least a quarterly basis.

Appendix 2: Laws and regulations referenced

A.2.1 EU law

Capital Requirements Regulation	Regulation (EU) 575/2013 of 26th June 2013
Commission Delegated Regulation (EU)	Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)
Directive 2014/59/EU	**Directive 2014/59/EU** of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council
UCITS	Undertaking for Collective investments in Transferable Securities as defined by the UCITS Directive
UCITS Directive	Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (as amended from time to time)
EBA Best practices	EBA Report on EU Covered Bond Frameworks and Capital Treatment, June 2014
Resolution Directive	Bank Recovery and Resolution Directive 2014/59/EU
European VAT Directive	Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax

A.2.2 Lithuanian law

Civil Code	The Civil Code of the Republic of Lithuania adopted by the Law No VIII-1864, dated 18 July 2000 as further amended from time to time (in Lithuanian – *Lietuvos Respublikos civilinis kodeksas*).
Civil Procedure Code	The Code of the Civil Procedure of the Republic of Lithuania adopted by the Law No IX-743, dated 28 February 2002, as further amended from time to time (in Lithuanian – *Lietuvos Respublikos civilinio proceso kodeksas*).
Companies Law	The Law on Companies of the Republic of Lithuania No VIII-1835 dated, 13 July 2000, as further amended from time to time (in Lithuanian – *Lietuvos Respublikos akcinių bendrovių įstatymas*).
Consumer Loan Law	The Law on Consumer Loan of the Republic of Lithuania No XI-1253 dated, 23 December 2010, as further amended from time to time (in Lithuanian – *Lietuvos Respublikos vartojimo kredito įstatymas*).
Law on Protection of Bondholders	The Law on Protection of the Interests of Bondholders of Public Limited Liability Companies and Private Limited Liability Companies No XII-2443, dated 16 July 2016 (in Lithuanian – *Lietuvos Respublikos akcinių bendrovių ir uždarųjų akcinių bendrovių obligacijų savininkų interesų gynimo įstatymas*).
Obligations Law	Book VI of the Civil Code.
FCA Law	The Law on Financial Collateral Arrangements of the Republic of Lithuania No IX-2127, dated 15 April 2004, as further amended from time to time (in Lithuanian - *Lietuvos Respublikos finansinio užtikrinimo susitarimų įstatymas*).
Law on Financial Institutions	The Law on Financial Institutions of the Republic of Lithuania No IX-1068, dated 10 September 2002, as further amended from time to time (in Lithuanian – *Lietuvos Respublikos finansų įstaigų įstatymas).*
Law on Banks	The Law on Banks of the Republic of Lithuania No IX-2085, dated 30 March 2004, as further amended from time to time (in Lithuanian – *Lietuvos Respublikos bankų įstatymas).*
Law on Collective Investment Undertakings	The Law on the Collective Investment Undertakings of the Republic of Lithuania No IX-1709, dated 4 July 2004, as further amended from time to time (in Lithuanian – *Lietuvos Respublikos kolektyvinio investavimo subjektų įstatymas).*
Bankruptcy Law	Law on Bankruptcy of the Enterprises of the Republic of Lithuania No IX-216, dated 20 March 2001, as further amended from time to time (in Lithuanian – *Lietuvos Respublikos įmonių bankroto įstatymas*).
Law on Restructuring	The Law on Restructuring of Enterprises of the Republic of Lithuania No IX-218, dated 20 March 2001, as further amended from time to

	time (in Lithuanian - *Lietuvos Respublikos įmonių restruktūrizavimo įstatymas*).
Resolution on Medium Sized Issues	Resolution of the Bank of Lithuania of 28 February 2013 No 03-45 Regarding Requirements for the Preparation of the Information Document for Public Offering of Medium Sized Issues and Exemptions for its Preparation, as further amended from time to time (in Lithuanian – *Lietuvos banko nutarimas "Dėl Informacinio dokumento, privalomo rengti viešai platinant vidutinio dydžio emisijas, rengimo reikalavimų ir išimčių, kai jo rengti nereikia, patvirtinimo"*).
Law on Protection of Consumer Rights	The Law on Protection of Consumer Rights of the Republic of Lithuania No I-657, dated 10 November 1994, as further amended from time to time (in Lithuanian – *Lietuvos Respublikos vartotojų teisių apsaugos įstatymo)*
Law on VAT	The Law on Value Added Tax of the Republic of Lithuania No IX-751, dated 5 March 2002, as further amended from time to time (in Lithuanian – Lietuvos Respublikos pridėtinės vertės mokesčio įstatymas)
Law on CIT	The Law on Corporate Income Tax of the Republic of Lithuania No IX-675, dated 20 December 2001, as further amended from time to time (in Lithuanian – *Lietuvos Respublikos pelno mokesčio įstatymas*)
Law on PIT	The Law on Personal Income Tax of the Republic of Lithuania No IX-1007, dated 2 July 2002, as further amended from time to time (in Lithuanian – *Lietuvos Respublikos gyventojų pajamų mokesčio įstatymas*)
Law on Securities	The Law on Securities of Republic of Lithuania No X-1023, dated 18 January 2007, as further amended from time to time (in Lithuanian - *Lietuvos Respublikos vertybinių popierių įstatymas*)

Appendix 3: Glossary

Term	Definition
Backup Servicer	Normally, the originator of a transaction continues servicing the original transaction in both securitisations and covered bonds. In pre-agreed cases the SPV can obtain the authority to bring in a backup servicer to replace the originator as servicer.
Conditional pass through	Arrangement in covered bonds defined in either contract or statute (currently only in Poland) to address a potential inability of an issuer in distress to meet covered bond obligations when falling due. Typically specifies that a failure to make a bond repayment on the scheduled maturity date does not constitute an event of default. In such eventuality, the underlying bond converts to a floating rate security after its scheduled maturity date and will be repaid as and when the underlying cover assets can be liquidated for sufficient proceeds to make repayment in full. Used in contrast to soft bullet and hard bullet structures qv.
Contractual over-collateralisation	That amount of over-collateralisation in a cover pool which is included by virtue of contractual obligations voluntarily entered into by the issuer. It is typically set out in covenants of the bond documents. In the case of covered bonds it is typically in excess of statutory over-collateralisation. In the case of securitisations typically there is no minimum levels for statutory over-collateralisation. It is used to support the credit rating treatment of the bonds.
Cover Pool	The assets which constitute the security for the bonds (and associated senior obligations, for example to derivative counterparties). Consists of both primary and secondary assets. Typically subject to legal arrangements to segregate them from other assets owned by the issuer in order to ensure certainty of bondholder claim.
Cover Register	A record, usually with legal status and in a form defined by statute which contains information regarding the assets in the cover pool.
Cover Pool Monitor	In covered bond transactions, an individual or entity, independent of both the issuer as well as the supervisor with responsibilities defined under applicable covered bond law. The main responsibility of a cover pool monitor is to ensure that covered bonds are issued and managed in accordance with the law. Different member states have slightly differing definitions of and titles for this entity.
Coverage Test	In covered bond transactions a test defined in either statute or contract which measures an issuer's compliance with obligations to maintain a sufficient cover pool to support the then outstanding bonds. In securitisation transactions the test is not used as there is no ongoing obligation to change the cover pool.
Credit Enhancement	This is a general term for measures taken by the originator in a transaction structure to enhance the security, credit or ratings of the bonds. Cash collateral, profit retention and third party guarantees may serve as such measures in both covered bonds and securitisations. In the case of securitisations only, subordinated bonds may also serve as credit enhancement for more senior ranking bonds.
Hard bullet	A covered bond in which a failure to repay the principal on the scheduled maturity date constitutes an event of default. See also soft bullet and conditional pass through.

Term	Definition
Issuer	In securitisation transactions it is the SPV which issues the securities to the investors. In context of covered bonds it is the originator of the assets itself, i.e. the bank.
Liquidity Buffer	In covered bonds a pool of assets, other than primary assets, typically either cash or assets with a very short term, highly liquid characteristics, held in a cover pool in order to ensure that there is sufficient cash available for an issuer to meet principal and interest payments when they fall due without recourse to the liquidation of primary assets. In securitisation transactions liquidity assets may be held but their use is far less prevalent due to the lack of a fixed maturity pay-down schedule.
Liquidity Cover Ratio (“LCR”)	Rules specifying the assets which must be held by credit institutions in order to mitigate the risk of an inability to meet obligations falling due in stressed market conditions. Defined in the capital requirements regulation and the Commission’s Delegated Regulation EU 2015/61 with regard to liquidity coverage requirements for credit institutions. Covered bonds can qualify for categories 1B, 2A or 2B, depending on their characteristics. Securitisations can only qualify for level 2B currently.
Loan to value ratio (“LTV”)	With reference to mortgages the ratio between the balance due on a loan (either currently or at the loan’s inception) and the value of the property granted as security for the amounts due on that loan.
Mortgage Backed Securities (“MBS”)	Typically used to refer to securitisations (in contrast to covered bonds). Also RMBS (Residential MBS) and CMBS (Commercial MBS)
Net Present Value. (“NPV”)	In the context of coverage calculations the future value of assets or liabilities discounted according to a methodology typically specified in the national covered bond legislation or regulations.
Over-collateralisation	The difference between the value of the cover pool and the value of the liabilities which it acts as security for. Typically calculated on either a nominal or present value basis. Assets and liabilities are defined differently for these purposes in different member states
Originator	The entity which is assigning assets in the transaction (i.e. the primary owner of the assets).
Pass Through	A payment method where the payments to investors take place in the same time periods and are subject to the same fluctuations as receivables. Applying this method the cash flow regularly collected on receivables is regularly passed through to investors. Typically used in securitisations and, in exceptional circumstances only, in covered bonds.
Primary assets	Those assets which the covered bond programme was established to finance. Distinct from derivatives and substitute or liquidity assets.
Servicer	The entity that collects principal and the interests from the debtors and administers the assets after the transaction has closed. It is a common practise that the originators are acting as the servicers, however, exemptions may apply (see backup servicer).
Soft bullet	In covered bonds an arrangement defined in contract to address a potential inability of an issuer in distress to meet covered bond obligations when falling due. Typically specifies that a failure to make a bond repayment on the scheduled maturity date does not constitute an event of default. In such eventuality the underlying bond typically converts to a floating rate security after its scheduled maturity date and will be repaid if the underlying cover assets can be liquidated for sufficient proceeds to make repayment in full up

Term	Definition
	until a pre-determined date, typically one year after the scheduled maturity date. If repayment is not made by this pre-determined date an event of default results. Used in contrast to conditional pass through and hard bullet structures qv.
Special administrator	An entity responsible for the administration of the covered bond pool and programme for the benefit of the covered bond holders after the insolvency of the issuer or sponsor.
Special Bank	A credit institution established for and limited to the issuance of covered bonds, the acquisition of assets to secure them and limited other ancillary activities. Contrast with SPV.
Special Public Supervision	Supervision of covered bond issuers, programmes and covered pools undertaken specifically to protect the interests of covered bond holders, over and above the normal supervisory processes for credit institutions.
Special purpose vehicle ("SPV")	An independent legal entity used in some jurisdictions to own assets in order to ensure certainty of legal title for the benefit of bond holders. Contrast with Special Bank.
Statutory over-collateralisation	In covered bonds that amount of over-collateralisation which is required either by law or by regulations passed by the competent authority for the regulation and supervision of the issuer.
Substitute Assets	Assets held in addition to the primary assets, typically constituting derivatives and assets held for liquidity purposes.
Trustee	A third party appointed to act on behalf of investors.